

FINAL COURSE STUDY MATERIAL

PAPER 3

**Advanced Auditing and
Professional Ethics**

MODULE – 1



**BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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SYLLABUS

PAPER 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

(One Paper- Three hours - 100 marks)

Level of Knowledge: Advanced knowledge

Objectives:

- (a) To gain expert knowledge of current auditing practices and procedures and apply them in auditing engagements,
- (b) To develop ability to solve cases relating to audit engagements.

Contents:

1. **Auditing Standards, Statements and Guidance Notes**
Auditing and Assurance Standards (AASs); Statements and Guidance Notes on Auditing issued by the ICAI; Significant differences between Auditing and Assurance Standards and International Standards on Auditing.
2. **Audit strategy, planning and programming**
Planning the flow of audit work; audit strategy, planning programme and importance of supervision: review of audit notes and working papers; drafting of reports; principal's ultimate responsibility; extent of delegation; control over quality of audit work; reliance on the work of other auditor, internal auditor or an expert.
3. **Risk Assessment and Internal Control**
Evaluation of internal control procedures; techniques including questionnaire, flowchart; internal audit and external audit, coordination between the two.
4. **Audit under computerized information system (CIS) environment**
Special aspects of CIS Audit Environment, need for review of internal control especially procedure controls and facility controls. Approach to audit in CIS Environment, use of computers for internal and management audit purposes: audit tools, test packs, computerized audit programmes; Special Aspects in Audit of E-Commerce Transaction.
5. **Special audit techniques**
 - (a) Selective verification; statistical sampling; Special audit procedures; physical verification of assets, direct confirmation of debtors and creditors
 - (b) Analytical review procedures
 - (c) Risk-based auditing.
6. **Audit of limited companies**
Relevant provisions under the Companies Act, 2013 relating to Audit and Auditors and Rules made thereunder; Audit of branches; joint audits; Dividends and divisible profits-financial, legal, and policy considerations.

7. Rights, duties, and liabilities of auditors; third party liability.
8. Audit reports; Qualifications, notes on accounts, distinction between notes and qualifications, detailed observations by the statutory auditor to the management *vis-a-vis* obligations of reporting to the members.
9. Audit Committee and Corporate Governance
10. Provisions under the Companies Act, 2013 in respect of Accounts of Companies and Rules made thereunder. Audit of Consolidated Financial Statements, Audit Reports and Certificates for Special Purpose engagements; Certificates under the Payment of Bonus Act, import/export control authorities, etc.; Specific services to non-audit clients; Certificate on Corporate Governance.
11. Special features of audit of banks, insurance companies, co-operative societies and non-banking financial companies.
12. Audit under Fiscal Laws, viz, Direct and Indirect Tax Laws.
13. Cost audit
14. Special audit assignments like audit of bank borrowers, audit of stock and commodity exchange intermediaries and depositories; inspection of special entities like banks, financial institutions, mutual funds, stock brokers.
15. Special features in audit of public sector companies. Directions of Comptroller and Auditor General of India to statutory auditors; Concepts of propriety and efficiency audit.
16. Internal audit, management and operational audit. Nature and purpose, organisation, audit programme, behavioural problems; Internal Audit Standards issued by the ICAI; Specific areas of management and operational audit involving review of internal control, purchasing operations, manufacturing operations, selling and distribution, personnel policies, systems and procedures. Aspects relating to concurrent audit.
17. Investigation and Due Diligence.
18. Concept of peer review
19. Salient features of Sarbanes – Oxley Act, 2002 with special reference to reporting on internal control.
20. **Professional Ethics**
Code of Ethics with special reference to the relevant provisions of The Chartered Accountants Act, 1949 and the Regulations thereunder.

Note:

- (i) **The provisions of the Companies Act, 1956 which are still in force would form part of the syllabus till the time their corresponding or new provisions of the Companies Act, 2013 are enforced.**
- (ii) **If new legislations are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from a date notified by the Institute.**

A WORD ABOUT STUDY MATERIAL

Auditing is, perhaps, one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit engagements. A good knowledge of the subject would provide a strong foundation to students while pursuing the Chartered Accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoying experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting and corporate laws in a meaningful manner. Such learning would only help a student to become a better professional.

The study material deals with the conceptual theoretical framework in detail. Its main features are as under:

- The entire syllabus has been divided into twenty two chapters.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and then can tackle the exercises.

Handbook on Auditing Pronouncements comprises of Standards on Auditing and Guidance Notes.

The Practice Manual aims to provide guidance as to the manner of writing an answer in the examination. Main features of Practice Manual are as under:

- After completing the Chapters of Study Material, Students are expected to attempt the questions and then compare it with the actual answers.
- Compilation of questions appearing during last twenty examinations.
- Exercises have been given at the end of each topic for independent practice.

This study material has been revised in view of Companies Act, 2013, Reporting under CARO, 2016, Notification/Circulars issued by MCA, CBDT, SEBI, RBI, ICAI including Listing Order Disclosure Requirements, Consolidated Financial Statements, Internal Controls, ICDS, Tax Audit Form 3CD, New and Revised Standards on Auditing etc. This revised study material contains the 'highlights of changes' in the tabular form to aid the students to know what and where the updates are made in the module. It may also be noted that Chapter 8, 9 and 10 are majorly revised therefore relevant page numbers are not given in table. The changes have been inserted in the bold italics for convenience of the students.

It is important to note that till the time Statements, Engagement and Quality Control Standards,

Guidance Notes, Code of Ethics etc. bare documents get updated from Auditing and Assurance Standard Board, Ethical Standard Board of ICAI and other Competent Authority in pursuance of the Companies Act, 2013, students are required to understand the basic nature of the provision and quote the same along with the new corresponding provisions.

- Attention is invited to the **Significant Additions/Modifications** made in this edition of the study material which are given on the next page.
- Please note that the changes over the previous edition have been indicated in **bold and italics** in the chapters.
- New case studies and Examples have been added to explain the application of the existing concepts in and these have been indicated in grey background.
- Diagrammatic Presentation has been made in most of Chapters for quick revision of described concept.
- Feedback form is given at the end of this study material wherein students are encouraged to give their feedback/suggestions.

In case you need any further clarification/guidance, please send your queries at karuna.bhansali@icai.in and Rajeev.sachdeva@icai.in.

SIGNIFICANT ADDITIONS IN THE REVISED EDITION

Chapter No.	Chapter Name	Section / Sub-Section wherein Additions / updation have been done	Page Number
1	Auditing Standards, Statements and Guidance Notes – An Overview	1.5 Quality Control and Engagement Standards 1.6.2 Guidance Note on Audit Reports and Certificates for Special Purposes 1.6.15 Guidance Note on Audit of Consolidated Financial Statements(CFS) 1.6.16 Guidance Note on CARO 2016 1.6.17 Guidance Notes on Audit of Internal Financial Controls over Financial Reporting 1.6.18 Guidance Note on Reporting on Fraud under section 143(12) of the Companies Act, 2013 1.8.5 Ind AS (Indian Accounting Standards)	1.6 1.9 1.15 1.16 1.16 1.16 1.21
3	Risk Assessment and Internal Control	3.2 Internal Control System - Nature, Scope, Objectives and Structure 3.3 Components of Internal Controls 3.4 Review of the System of Internal Controls	3.2 3.7 3.13
6	The Company Audit	Insertion of Example on Section 144 Insertion of Example on Auditor Rotation Clarification on Auditor's Rotation Provision 6.6.1 Removal of Auditor before Expiry of Term 6.6.2 Appointment of Auditor other than retiring Auditor	6.7 6.13 6.14 6.19 6.20

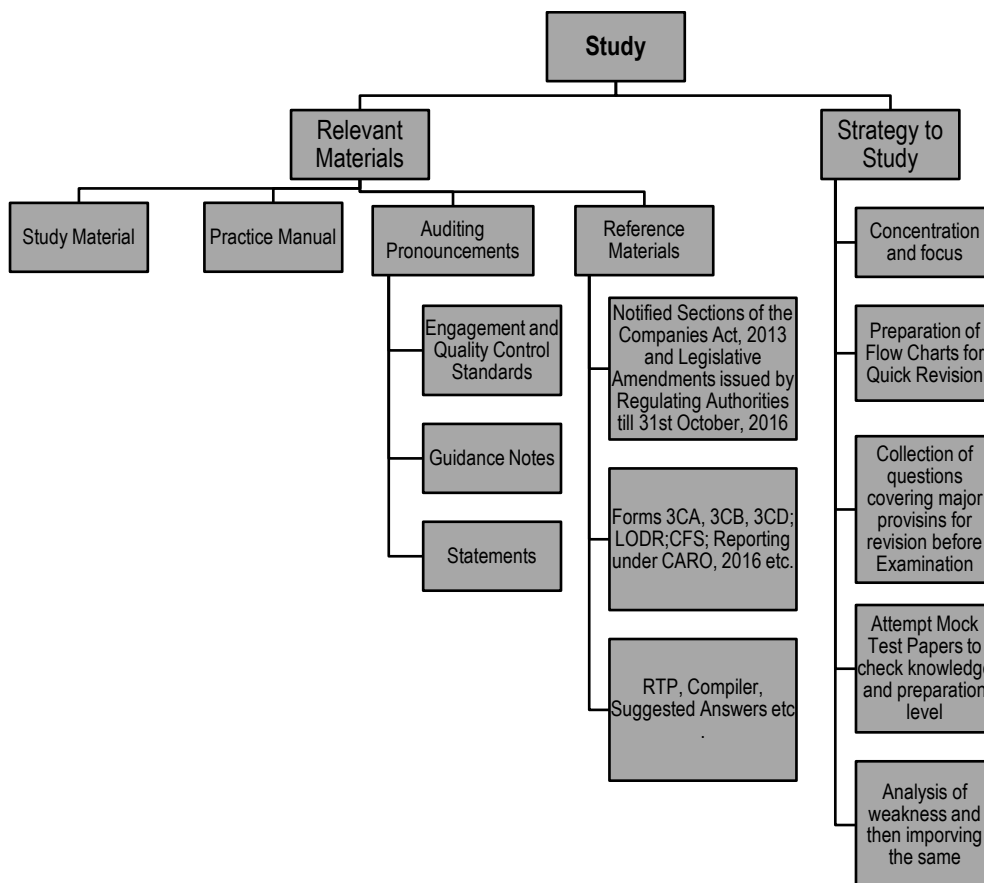
		6.9 Duties of Auditors	6.29
		6.14 Cost Audit	6.43
		6.16.1 Financial Statements	6.47
		6.16.2 Consolidated Financial Statement	6.48
		6.16.5 Form of the Balance Sheet	6.51
		Appendix- General Instructions for preparation of Balance Sheet	6.71
7	Liabilities of Auditor	7.5 Criminal Liability under the Companies Act	7.20
8	Audit Report	Almost Complete Chapter	
9	Audit Committee and Corporate Governance	Almost Complete Chapter	
10	Audit of Consolidated Financial Statements	Almost Complete Chapter	
11	Audit of Banks	11.1 Introduction	11.1
		11.3 Form and Content of Financial Statements	11.2
		11.4 Audit of Accounts	11.4
		Announcement on Demonetisation	11.10
		11.5.11 Compliance with CRR and SLR requirements	11.16
		11.6 Verification of Assets and Balances	11.21
14	Audit of Non-Banking Financial Companies	14.5.2 Compliance with CARO 2016:	14.16
15	Audit under Fiscal Laws	15.3.2 Income Computation and Disclosure Standards (ICDS)	15.11
		15.3.4 Clause 13 (d), (e), (f) of Form 3CD	15.26
16	Cost Audit	16.6 Cost Audit under the Companies Act	16.10
17	Special Audit Assignments	17.9.2 Audit Report	17.23

18	Audit of Public Sector Undertakings	18.9.3 Propriety elements under CARO,2016	18.23
19	Internal Management Audit, and Operational Audit	19.6 Relationship between Internal and External Auditors	19.12
20	Investigation and Due Diligence	Reporting of Fraud under section 143(12)	20.3
22	Professional Ethics	<p>22.4.5 MEMBER IN PRACTICE PROHIBITED FROM USING A DESIGNATION OTHER THAN CHARTERED ACCOUNTANT</p> <p>22.8 Schedules to the Act:</p> <p>(i) The First Schedule-Part 1: Insertion of Proviso in Clause 6</p> <p>(ii) Website Guidelines in Clause 6</p> <p>(iii) Regulation 192. Restriction on fees</p> <p>(iv) Insertion in General Resolution in Clause 11</p>	<p>22.11</p> <p>22.22</p> <p>22.24</p> <p>22.46</p> <p>22.48</p>

STUDY PLAN – KEY TO EFFECTIVE LEARNING

As Benjamin Franklin said, “By failing to prepare, you are preparing to fail.” Preparation is first and very important step towards success. For doing preparation of CA. Final Paper 3 - Advanced Auditing and Professional Ethics Examination, one has to be very careful as preparation consists of Study as well as Revision.

When you are starting for studies you must have all relevant material for subject and strategy to study. Study includes all relevant and reference material whereas strategy tells us how to effectively use the same. In absence of any of both it will be difficult to get through.



Refer the diagram given above it is important to note that Latest Study Material and Practice Manual which is further divided in into twenty two chapters in our study material covering in detail, principles of Auditing, Standards on Auditing issued by the ICAI, reporting on internal control as a part of Risk Assessment and Internal Control,

specific audit issues classified by organizations like Company Audit, Audit of Banks, Audit of General Insurance Business, Audit of Co-Operative Societies, NBFCs and Audit of Public Sector Undertakings, special audit issues like audit under Fiscal Laws, role of auditor as per Listing Order and Disclosure Requirements, Audit of Consolidated Financial Statements, Investigation and Due Diligence and Salient features of Sarbanes Oxley Act, 2002. In addition to above, Peer Review is considered as an important step towards maintenance and improvement of audit quality. Similarly, Professional Ethics are regarded as a foundation to the audit function, which is essentially developed on the foundation of ethical norms, which has so far brought name and fame to the profession. All students of Final course should read these chapters with sincerity and imbibe the norms explained. These Chapters are comprehensively covered in our Latest Study Material incorporating all relevant changes.

Students may also note that relevant notified Sections of the Companies Act, 2013 and other legislative amendments i.e. Rules, significant notifications and circulars issued by SEBI, RBI, NBFC, MCA etc up to 31st October, 2016 are applicable for May, 2017 and up to 30th April, 2017 are applicable for November, 2017 & onward Examination.

Students must go through the Study Material along with other reference materials. It is important to note that auditing is largely a practical and application discipline. Students should learn the Auditing concepts and techniques as also their intricacies purely for purposes of applying them in practice in their audit work.

For the purpose of its full coverage syllabus of this paper may be segregated into following seven parts for preparation:

Part I	Engagements and Quality Control Standards on Auditing (SA/SRS/SRE/SAE) and Guidance Notes
Part II	Audit strategy, planning and programming, Risk Assessment and Internal Control, Audit under computerized information system (CIS) environment, Special audit techniques
Part III	Audit of limited companies, Rights, duties, and liabilities of auditors; third party liability, Audit Committee and Corporate Governance
Part IV	Audit Reports, Audit of Consolidated Financial Statements, Certificate on Corporate Governance
Part V	Special features of audit of banks, insurance companies, co-operative societies and non-banking financial companies, Audit under Fiscal Laws, viz, Direct and Indirect Tax Laws, Cost audit, Special audit assignments like audit of bank borrowers, audit of stock and commodity exchange intermediaries and depositories; inspection of special entities like banks,

	financial institutions, mutual funds, stock brokers.
Part VI	Special features in audit of public sector companies, Internal Audit, Management and Operational Audit, Investigation and Due Diligence, Concept of Peer Review.
Part VII	Professional Ethics

In first part you may prepare Engagements and Quality Control Standards on Auditing (SA/SRS/SRE/SAE) and Guidance Notes for which list of applicable standards are published by ICAI from time to time. For doing preparation for Part First, read the bare standard along with its application and other explanatory material. After reading this you are advised to draw a flow chart or some diagrammatic presentation for your better understanding and revision purpose. You are also expected to focus on the application aspects of each of the Auditing Standards and guidance notes. As it is important to have the basic understanding, the objective is to the gain the ability to practice the same in the working scenario.

In part two, you may prepare audit strategy, planning and programming, risk assessment and internal control evaluation, audit under computerized information system (CIS) environment, special audit techniques like selective verification; statistical sampling; special audit procedures; physical verification of assets, direct confirmation of debtors and creditors, analytical review procedures, risk-based auditing etc. While doing preparation for this part, you may interlink it with Auditing Standards, specially the series of SA 300 – 499 i.e. Risk Assessment and Response to Assessed Risks and series of SA 500 – 599 Audit Evidence.

For the preparation of Audit Strategy, Planning and Programming, you should practice developing an “Engagement Approach Document”. The Approach document should primarily outline the activity based scoping of an engagement and planning of the procedures for each of the activity. An Approach Document should treat each engagement as a project which would highlight the resource requirements in each activity area and scheduling as well. Similarly for the Risk Assessment and Internal Control Evaluation you should gain understanding of the Risk Management Framework, relevance of control procedures, control assessment questionnaires and the complementary role that the internal and external audit plays. Further you should apply the accounting knowledge; and business intelligence framework along with the ratio analysis and trend reviews for any un-reasonable gaps in inputs provided / made available.

In part three, you may incorporate audit of limited companies, rights, duties and liabilities of auditors, third party liability and Audit Committee and corporate governance. For better understanding, you must have good knowledge of the Companies Act which is pre-requisite. Not only knowledge but updation of knowledge is also required on time to time basis.

In part four, you may include Audit Reports, Reporting under CARO, 2016 and Audit of Consolidated Financial Statements. While doing study of Audit Reports, you may interlink this with series of SA 700-799 i.e. Audit Conclusion and Reporting and sections 143 of the Companies Act, 2013. You are also required to practice the drafting of qualifications. You may also scan through the Annual Financial Statements of Companies to analyse the notes and qualifications, if any, incorporated by the Auditors in their Audit Report.

In part five, you may include miscellaneous audits like audit of banks, insurance companies, co-operative societies, NBFCs, audit under fiscal laws, cost audit and special audit assignments. For the preparation of part five, deep knowledge of statutory requirements is a pre-requisite for validation to adherence of the business with applicable laws. For this you should follow a check-list approach ensuring completeness of compliance validations. Further, you should update yourself with latest notification, circulars etc. You may also interlink the above part with guidance notes already covered in part one.

In part six, you should prepare special features in audit of public sector companies, internal audit, management and operational audit, investigation and due diligence and concept of peer review. For the preparation of this part, you are again required to have sound knowledge of statutory requirements.

Last but not the least; in the seventh part you may prepare Professional Ethics. Generally it has been observed that there is one question i.e. case studies based question of 16 marks in the examination paper. For better preparation of this part you are advised to read the 22 Chapter of the Study Material in detail which elaborates this topic along with examples. Further, you may write down all the clauses in notes form for the revision purpose.

While answering the case studies based question, answer should be split in to two parts, first one is Facts of the case and second one is the relevant concept and finally give your own conclusion. In this way the case study and application oriented theory questions can be answered.

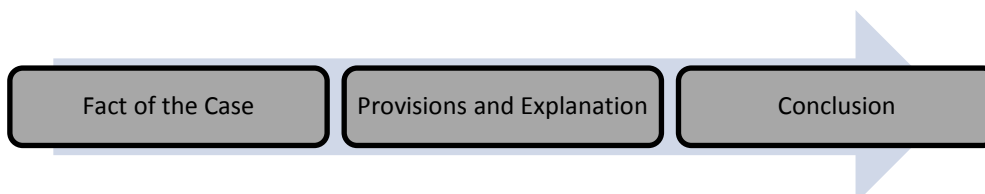


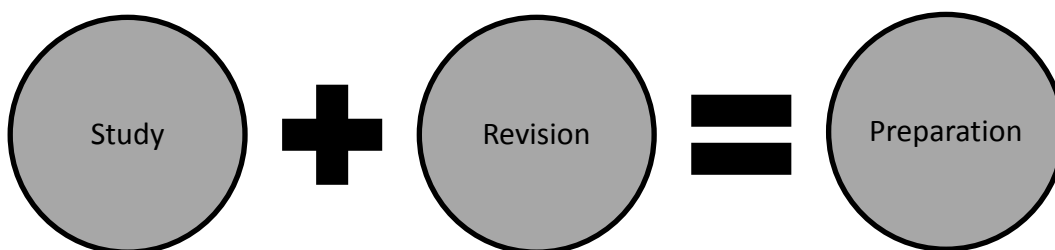
Diagram showing Steps for Answering of Case Study

As in all other subjects of CA course, to excel in Audit proper preparation and planning is very much required to avoid failure. Further Audit is a paper which requires a

practical approach towards actual Audit work. You should in the first instance focus on studying Auditing concepts, procedures and techniques from the study material. The knowledge being so derived may be related by the students to the practical work in the field of Auditing which they do as part of their Articles training.

Part three, five and six are based on statutory requirements. Therefore, you must be cautious about the amendments and updates happened at least six months before the exam and also go through the other amendments. Further, you should also take a keen interest in updating yourself on contemporary developments in the field of auditing by regularly referring to articles on Auditing in CA Journal, Students' monthly Journal and other relevant professional journals, publications and books. It is also advisable to mention applicable Engagement Quality Control Standards or Accounting Standards or Sections in audit paper wherever required. Answers should be crisp, precise and to the point to secure good marks.

Audit is a subject that requires a lot of quick and logical application of mind to answer practical problems. Hence, give a reading to ICAI audit study material and Practice Manual to understand the depth and figure out the efforts and time required for preparation. In addition to study material suggested answers of past examination, Revisionary Test Papers, Standard books should also be read.



Your study and preparation should be in such manner that you are able to revise the same in one day time span. Finally don't forget to revise as already shown in diagram Study and Revision both are essential for Preparation for Examination.

“Give me six hours to chop down a tree and I will spend the first four sharpening the axe.” – Abraham Lincoln

Happy Reading and Best Wishes!

CONTENTS

MODULE – 1

- Chapter 1 – Auditing Standards, Statements and Guidance Notes – An Overview
- Chapter 2 – Audit Strategy, Planning and Programming
- Chapter 3 – Risk Assessment and Internal Control
- Chapter 4 – Audit under Computerised Information System (CIS) Environment
- Chapter 5 – Special Audit Techniques
- Chapter 6 – The Company Audit
- Chapter 7 – Liabilities of Auditors
- Chapter 8 – Audit Report
- Chapter 9 – Audit Committee and Corporate Governance
- Chapter 10 – Audit of Consolidated Financial Statements

MODULE – 2

- Chapter 11 – Audit of Banks
- Chapter 12 – Audit of General Insurance Companies
- Chapter 13 – Audit of Co-Operative Societies
- Chapter 14 – Audit of Non Banking Financial Companies
- Chapter 15 – Audit under Fiscal Laws
- Chapter 16 – Cost Audit

MODULE – 3

- Chapter 17 – Special Audit Assignments
- Chapter 18 – Audit of Public Sector Undertakings
- Chapter 19 – Internal Audit, Management and Operational Audit
- Chapter 20 – Investigation and Due Diligence
- Chapter 21 – Peer Review
- Chapter 22 – Professional Ethics

DETAILED CONTENTS: MODULE – 1

CHAPTER 1 : AUDITING STANDARDS, STATEMENTS AND GUIDANCE NOTES - AN OVERVIEW

1.1	Introduction	1.1
1.2	Historical Retrospect.....	1.1
1.3	Auditing and Assurance Standards Board – Scope and Functions.....	1.2
1.4	Framework of Standards and Guidance Notes on Related Services	1.5
1.5	Quality Control and Engagement Standards	1.6
1.6	Guidance Notes	1.8
1.7	Guidance Note(s) on Related Services	1.17
1.8	Authority Attached to the Documents issued by the Institute	1.17

CHAPTER 2: AUDIT STRATEGY, PLANNING AND PROGRAMMING

2.1	Commencing an Audit	2.1
2.2	Overall Audit Strategy	2.4
2.3	Audit Programme	2.8

CHAPTER 3: RISK ASSESSMENT AND INTERNAL CONTROL

3.1	Introduction	3.1
3.2	Internal Control System - Nature, Scope, Objective and Structure.....	3.2
3.3	Components of Internal Control	3.7
3.4	Review of the System of Internal Controls	3.13
3.5	Methods of Recording	3.15
3.6	Internal Control and Risk Assessment	3.26
3.7	Internal control in Small Business Enterprises	3.34
3.8	Reporting to clients on Internal Control Weaknesses	3.34
	Annexure -The Sarbanes – Oxley Act of 2002.....	3.37

CHAPTER 4: AUDIT UNDER COMPUTERISED INFORMATION SYSTEM (CIS) ENVIRONMENT

4.1	Introduction	4.1
4.2	Scope of Audit in a CIS Environment.....	4.2
4.3	Impact of changes on Business Processes (for shifting from manual to electronic medium).....	4.3
4.4	Audit Approach in a CIS environment	4.5
4.5	Effect of Computers on Internal Controls	4.7
4.6	Effects of Computers on Auditing	4.9
4.7	Internal controls in a CIS environment.....	4.10
4.8	Consideration of Control Attributes by the Auditors	4.11
4.9	Internal control requirement under CIS Environment.....	4.12
4.10	Auditing in a CIS Environment.....	4.13
4.11	Review of Checks and Controls in a CIS Environment	4.16
4.12	Computer assisted audit techniques (CAATs)	4.22

CHAPTER 5: SPECIAL AUDIT TECHNIQUES

5.1	Introduction	5.1
5.2	Statistical Sampling in Auditing	5.11
5.3	Risk-Based Audit	5.23

CHAPTER 6: THE COMPANY AUDIT

6.1	Eligibility, Qualifications and Disqualifications of an Auditor	6.1
6.2	Appointment of auditor	6.8
6.3	Rotation of Auditor.....	6.12
6.4	Provisions relating to Audit Committee.....	6.17
6.5	Auditor's Remuneration	6.19
6.6	Removal of Auditors	6.19
6.7	Ceiling on number of audits	6.20
6.8	Powers/Rights of Auditors.....	6.23

6.9	Duties of Auditors.....	6.27
6.10	Audit Report.....	6.38
6.11	Disclosure in the Auditor Report	6.38
6.12	Joint Audit.....	6.39
6.13	Audit of Branch Office Accounts.....	6.41
6.14	Cost Audit	6.43
6.15	Punishment for non-compliance	6.46
6.16	Financial Accounts Preparation and Presentation.....	6.46
6.17	Significance of True and Fair	6.51
6.18	Divisible Profits, Dividends and Reserves	6.54
6.19	Depreciation.....	6.69
	Appendix- Schedule III to the Companies Act, 2013	6. 71

CHAPTER 7: LIABILITIES OF AUDITORS

7.1	Nature of Auditor's Liability	7.1
7.2	Professional Negligence.....	7.3
7.3	Cases Concerning the Civil Liability of Auditors for Negligence.....	7.12
7.4	Civil Liabilities under the Companies Act.....	7.14
7.5	Criminal Liability under the Companies Act.....	7.19
7.6	Cases Concerning the Misconduct of Auditors under the Chartered Accountants Act.....	7.22
7.7	Liabilities under Income Tax Act, 1961	7.25

CHAPTER 8: AUDIT REPORT

8.1	Auditor's opinion	8.1
8.2	The Auditor's Report on Financial Statements	8.1
8.3	Reporting Under CARO, 2016	8.27
8.4	Distinction between Audit Report and Certificate	8.32
8.5	Audit Reports and Certificates for Special Purposes	8.34
8.6	Reporting Requirements in case of Comparative Information	8.37

Appendix 1: Comprehensive Format on the Audit Report.....	8.41
Appendix 2: Comprehensive Case Studies on CARO 2016	8.49
Appendix 3: Key Aspects discussed in Guidance Note on Reporting of Fraud under section 143(12) of the Companies Act 2013.....	8.58
Appendix 4: Key Aspects Discussed in Guidance Note on Reporting Under Section 143(3) (F) and (H) of the Companies Act, 2013.....	8.60
Appendix 5: Key Aspects discussed in Guidance Note on Internal Financial Control over Financial Reporting.....	8.63

CHAPTER 9: AUDIT COMMITTEE AND CORPORATE GOVERNANCE

9.1	Introduction	9.1
9.2	Corporate Governance	9.1
9.3	The Legal Framework	9.1
9.4	Audit Committee under LODR Regulations	9.3
9.5	Audit Committee under Section 177 of the Companies Act, 2013	9.6
9.6	Functions of the Audit Committee	9.6
9.7	Review of Information by Audit Committee	9.8
9.8	Role of Auditor in Audit Committee and Certification of Compliance of Conditions of Corporate Governance	9.8
9.9	Remuneration of Directors [Part C of Schedule V]	9.11
9.10	Obligations of Director and Senior Management [Regulations 17(2) to 17(4), 25(5) to 25(6), 26(1) to 26 (2), 26(4) to 26(5)]	9.13
9.11	Code of Conduct [Regulations 17(5), 26(3), 46(2) and Part D of Schedule V]	9.15
9.12	Vigil Mechanism [Regulations 22 and 46 and Part C of Schedule V].....	9.15
9.13	Subsidiary of Listed Entity [Regulations 16(c), 24 and 46 and Part C of Schedule V]	9.15
9.14	Statement of Deviation(s) or Variation(s) [Regulation 32 and Part C of Schedule II].....	9.17
9.15	Disclosures - Management Discussion and Analysis [Schedule V]	9.17
9.16	Information to Shareholders [Regulation 36]	9.18
9.17	Stakeholders Relationship Committee [Regulation 20 and Part D of Schedule II].....	9.18
9.18	Transfer or Transmission or Transposition of Securities [Regulation 40]	9.19

9.19	Compliance Certificate [Part B of Schedule II]	9.19
9.20	Disclosures	9.21
9.21	Risk Management Committee [Regulation 21].....	9.21
9.22	Nomination and Remuneration Committee [Regulation 19 and Part D of Schedule II]	9.22
9.23	Report on Corporate Governance [Regulation 27 and Schedule II]	9.23
9.24	Auditors' Certificate	9.23
	Appendix: Corporate Governance – Schedule II to the SEBI (LODR) Regulations, 2015	9.26

CHAPTER 10: AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS

10.1	Introduction	10.1
10.2	Definitions	10.3
10.3	Responsibility of Parent	10.4
10.4	Responsibility of the Auditor of the Consolidated Financial Statements	10.5
10.5	Audit Considerations	10.6
10.6	Auditing the Consolidation.....	10.8
10.7	Special Considerations	10.11
10.8	Management Representations	10.17
10.9	Reporting.....	10.17

Auditing Standards, Statements and Guidance Notes – An Overview

1.1 Introduction

The past decade has been one of unprecedented change in the global economy and capital markets. Key aspects of the current business environment include a globalized, highly competitive, expanding economy; explosive growth in the development and use of technology; dramatic increases in new economy service- and technology-based businesses with predominantly intangible assets; unparalleled expansion in the number of public entities; large increases in the number of individuals who directly or indirectly own equity securities; and unprecedented growth in the market value of those securities.

The expanded use of technology in both the operating and financial systems of companies also has significantly affected the audit environment, forcing audit firms to recruit, train and deploy a large number of information technology specialists to support their audit efforts. It also has caused firms to reconsider their audit methods and techniques in an effort to harness technology to improve audit efficiency and effectiveness.

In the changing environment, it is obvious that a professional accountant should to adhere to standards and procedures laid down by the professional accountancy bodies of which he is a member while discharging his duties in a responsible manner. In this direction, the role of a professional accounting body is to lay down such standards and procedures with the aim of providing guidance to members. The Institute of Chartered Accountants of India (ICAI) has been formulating auditing and accounting standards for the guidance of its members on its own volition in the larger interests of the society. In this chapter, we provide an overview of auditing standards and guidance notes issued by the Institute from time to time. Though these standards and guidance notes have been dealt at appropriate places, the main purpose is to acquaint and inculcate appreciation on the part of students in a focused manner as to significance of the standards in their day to day auditing activities. Towards the end of the Chapter, the clarification issued by the Council of the Institute is also included, which would go a long way in understanding as well as significance to the mandatory status of “Statements” and “Standards”.

1.2 Historical Retrospect

The Institute, since its inception, has been committed to research in the field of accountancy. As early as in 1955, the Council set up the Research Committee. The Council at that point of time felt the necessity to establish such a Committee to deal with the growing complexities of

1.2 Advanced Auditing and Professional Ethics

the problems faced by membership at large and with a view to ensuring the highest of traditions and technical competence in the discharge of the duties by chartered accountants.

As back as in 1964, the Council published the “Statement on Auditing Practices” as prepared by the Research Committee not only for the benefit of its members but also for others outside the profession, who might be interested in this subject. It was hoped that this Statement would provide valuable guidance in the performance of audits, particularly of companies. The Council of the Institute fully realised that techniques of accounting and auditing had undergone and were undergoing important changes. Since the members were expected to keep pace with recent developments, this Statement attempted to set out practices which were generally accepted in other countries and which the Council considered desirable in the light of prevailing circumstances in India. The issuance of the Statement on Auditing Practices might be considered as a path break as far as establishing sound auditing practices is concerned. The Statement was further revised in 1968 and 1977.

Prior to establishment of the Auditing Practices Committee (APC), the Research Committee issued the following Statements in Auditing:

- ◆ Statements on Qualifications in Auditor’s Report.
- ◆ Statement on the Manufacturing and Other Companies (Auditor’s Report) Order, 1975/1988 (Issued under Section 227(4A) of the Companies Act, 1956).
- ◆ Statement on Responsibilities of Joint Auditors.
- ◆ Statement on Payments to Auditors for Other Services.

1.3 Auditing and Assurance Standards Board – Scope and Functions






The Following are the important points as regards scope and functions of Auditing and Assurance Standards Board –

1.3.1 Setting up of AASB

The International Federation of Accountants (IFAC) came into existence in 1977 and constituted International Auditing Practices Committee (IAPC) to formulate International Auditing Guidelines. These guidelines were later on converted into International Standards on Auditing (ISA). Considering the developments in the field of auditing at international level, the need for issuing Standards and Guidance Notes in tandem with international standards but conforming to national laws, customs, usages and business environments was felt. With this objective, our Institute constituted the Auditing Practices Committee (APC) on September 17, 1982, to spearhead the new framework of Statements on Standard Auditing Practices (SAPs) and Guidance Notes (GNs) *inter alia* to replace various chapters of the old omnibus Statement on Auditing Practices issued in 1964.

In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of

representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of SAPs had been changed to Auditing and Assurance Standards (AASs). As per the Preface to Standards on Quality Control Auditing Review, other Assurance and Related Services w.e.f. April 1, 2008, the nomenclature of AASs under the authority of the Council are collectively known as the Engagement Standards and Quality Control Standards which include the following:

-  Standards on Auditing (SAs), to be applied in the audit of historical financial information.
-  Standards on Review Engagements (SREs), to be applied in the review of historical financial information.
-  Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.
-  Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.
-  Standard on Quality Control which contains extensive requirements in relation to establishment and maintenance of a system of quality control in the audit firms as well as even for sole practitioners.

1.3.2 Scope and Functions of AASB

The main function of the AASB is to review the existing auditing practices in India and to develop Statements on Standards on Auditing (SAs) so that these may be issued by the Council of the Institute. While formulating the SAs, the AASB takes into consideration the ISAs issued by the IAPC, applicable laws, customs, usages and business environment in India. The SAs are issued under the authority of the Council of the Institute. The AASB also issues Guidance Notes on the issues arising from the SAs wherever necessary. The AASB has also been entrusted with the responsibility to review the SAs at periodical intervals.

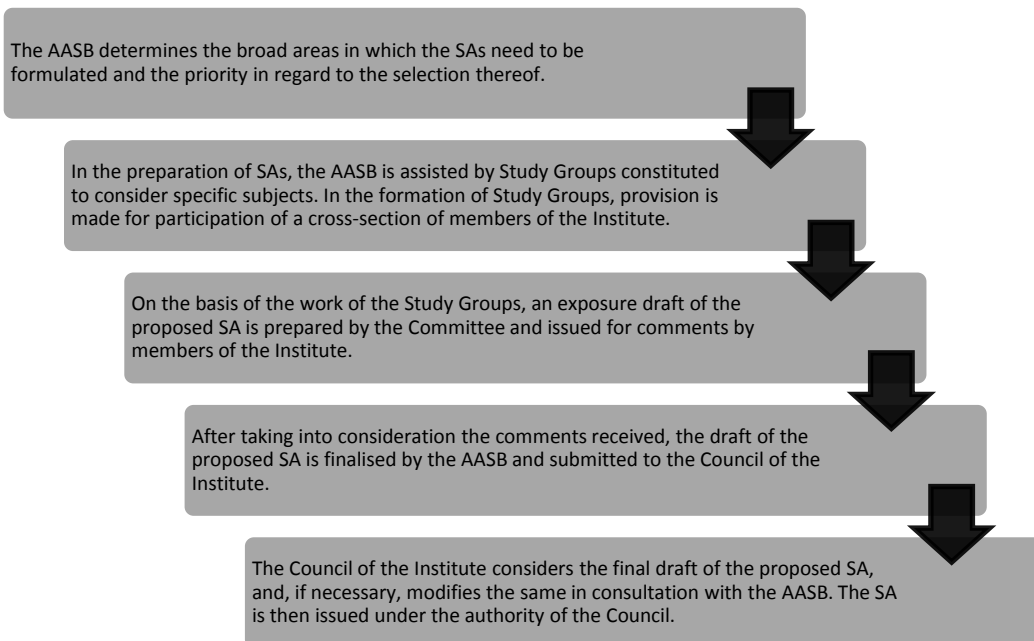
1.3.3 Scope of SAs

The SAs apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion. The SAs may also have application, as appropriate, to other related functions of auditors. Any limitation on the applicability of a specific SA is made clear in the introductory paragraph of the SA.

1.4 Advanced Auditing and Professional Ethics

1.3.4 Procedure for issuing SAs

Broadly, the following procedure is adopted for the formulation of SAs:



1.3.5 Compliance with the SAs

While discharging their attest function, it is the duty of the members of the Institute to ensure that the SAs are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the SAs, his report should draw attention to the material departures therefrom. Auditors are expected to follow SAs in the audits commencing on or after the date specified in the Standard. Further, compliance of SAs are mandatory requirement as per the Companies Act, 2013.

1.3.6 Linkage between SAs and Disciplinary Proceedings

The SAs (as well as other statements on auditing) represent the generally accepted procedure(s) of audit. As such, a member who does not perform his audit in accordance with these statements and fails to disclose the material departures there from, becomes liable to the disciplinary proceedings of the Institute under Clause (9) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 (as amended by the Chartered Accountants (Amendment) Act, 2006), which specifies that a member of the Institute engaged into practice shall be guilty of professional misconduct if he “fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances”.

1.4 Framework of Standards and Guidance Notes on Related Services

Framework of Standards on Auditing and Guidance Notes on Related Services issued recently distinguishes audits from related services. Related services comprise reviews, agreed-upon procedures and compilations. As illustrated in the diagram below, audits and reviews are designed to enable the auditor to provide high and moderate levels of assurance respectively, such terms being used to indicate their comparative ranking. Engagements to undertake agreed-upon procedures and compilations are not intended to enable the auditor to express assurance.

	Auditing	Related Services			
Nature of service	Audit	Review	Agreed-upon Procedures	Compilation	
Comparative level of assurance provided by the auditor	High, but not absolute assurance	Moderate assurance	No assurance	No assurance	
Report provided	Positive assurance on assertion(s)	Negative assurance on assertion(s)	Factual findings of procedures	Identification of information compiled	

Assurance in the above context refers to the auditor's satisfaction as to the reliability of an assertion being made by one party for use by another party. To provide such assurance, the auditor assesses the evidence collected as a result of procedures conducted and expresses a conclusion. The degree of satisfaction achieved and, therefore, the level of assurance which may be provided is determined by the procedures performed and their results. In an audit engagement, the auditor provides a high, but not absolute, level of assurance (i.e. reasonable level of assurance) that the information subject to audit is free of material misstatement expressed positively in the audit report. In a review engagement, the auditor provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of negative assurance (also known as limited assurance). For agreed-upon procedures, auditor simply provides a report of the factual findings, no assurance is expressed. Instead, users of the report draw their own conclusions from the auditor's work. In a compilation engagement, although the users of the compiled information derive some benefit from the involvement of a member of the Institute, no assurance is expressed in the report. Objective of an audit is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework "give a true and fair view". Absolute assurance in auditing is not attainable as a result of such factors as the need for judgement, the use of test checks, the inherent limitations of any accounting and internal control systems and the fact that most of the evidence available to the auditor is persuasive, rather than conclusive, in nature. The objective of a review of financial statements is to enable

1.6 Advanced Auditing and Professional Ethics

an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework. While a review involves the application of audit skills and techniques and the gathering of evidence, it does not ordinarily involve an assessment of accounting and internal control systems, tests of records and of responses to inquiries by obtaining corroborating evidence through inspection, observation, confirmation and computation, the auditor attempts to become aware of all significant matters, the procedures of a review make the achievement less likely than in an audit engagement, thus the level of assurance provided in a review report is correspondingly less than that given in an audit report. In an engagement to perform agreed-upon procedures and auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. In a compilation engagement, a member of the Institute is engaged to use accounting expertise as opposed to auditing expertise to collect, classify, and summarize financial information. The procedures employed are not designed and do not enable the member to express any assurance on the financial information. However, users derive some benefit as a result of the member's involvement because the service has been performed with due professional skill and care. An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection. If the auditor is not associated in this manner, third parties can assume no responsibility of the auditor.

1.5 Quality Control and Engagement Standards

The Council of the ICAI has issued following Quality Control and Engagement Standards:

S. No.	No. of Standard	Title of the Standard
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
3	SA 210	Agreeing the Terms of Audit Engagements
4	SA 220	Quality Control for an Audit of Financial Statements
5	SA 230	Audit Documentation
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements

7	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements
8	SA 260	Communication with Those Charged with Governance
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
10	SA 299	Responsibility of Joint Auditors
11	SA 300	Planning an Audit of Financial Statements
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
13	SA 320	Materiality in Planning and Performing an Audit
14	SA 330	The Auditor's Responses to Assessed Risks
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization
16	SA 450	Evaluation of Misstatements Identified during the Audits
17	SA 500	Audit Evidence
18	SA 501	Audit Evidence - Specific Considerations for Selected Items
19	SA 505	External Confirmations
20	SA 510	Initial Audit Engagements-Opening Balances
21	SA 520	Analytical Procedures
22	SA 530	Audit Sampling
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
24	SA 550	Related Parties
25	SA 560	Subsequent Events
26	SA 570	Going Concern
27	SA 580	Written Representations
28	SA 600	Using the Work of Another Auditor
29	SA 610	Using the Work of Internal Auditors
30	SA 620	Using the Work of an Auditor's Expert
31	SA 700	Forming an Opinion and Reporting on Financial Statements
32	SA 701	<i>Communicating Key Audit Matters in the Independent Auditor's Report</i>
33	SA 705	Modifications to the Opinion in the Independent Auditor's Report
34	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in

1.8 Advanced Auditing and Professional Ethics

		the Independent Auditor's Report
35	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements
36	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements
37	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework
38	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
39	SA 810	Engagements to Report on Summary Financial Statements
40	SRE 2400	Engagements to Review Historical Financial Statements
41	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity
42	SAE 3400	The Examination of Prospective Financial Information
43	SAE 3402	Assurance Reports on Controls At a Service Organisation
44	SAE 3420 (New)	<i>Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus</i>
45	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information
46	SRS 4410	Compilations Engagements

(Students may note that the abovementioned Quality Control and Engagement Standards are reproduced in Auditing Pronouncements)

1.6 Guidance Notes

Various technical committees of the Institute are involved in the task of issuing guidance notes on topics relating to accounting and auditing for guidance of the members. Some of the important topics in auditing on which guidance notes have been issued are discussed below:

1.6.1 Guidance Note on Independence of Auditors

Professional integrity and independence is an essential characteristic of any member of the accounting profession. A detailed note on this topic was first published by the Council in 1968. In the light of the experience gained over a period of years, this note was revised by the Council and published as a guidance note in 1975. The revised Guidance Note contains essentially a discussion on relevant section of the Companies Act and the provisions of the Chartered Accountants Act, 1949 which aim at ensuring independence of auditors.

1.6.2 Guidance Note on Audit Reports and Certificates for Special Purposes

The purpose of this Guidance Note is to provide guidance on engagements which require a ‘professional accountant in public practice’ (hitherto known as “practitioner”) to issue reports other than those which are issued in audits or reviews of historical financial information. The reports which are issued pursuant to audits or reviews of historical financial information are dealt with in Standards on Auditing (SAs) and Standards on Review Engagements (SREs), respectively, issued by the Institute of Chartered Accountants of India (ICAI).

In some cases, Government and other authorities under various statutes or notifications require reports or certificates from practitioners in support of statements or other information provided by an entity. Such reports or certificates can also be required to be issued to fulfill a contractual reporting obligation or may be required by the management or those charged with governance of an entity for its own special purposes.

Sometimes, the applicable law and regulation or a contractual arrangement that an entity might have entered into, prescribe the wording of report or certificates. The wording often requires the use of word or phrase like “certify” or “true and correct” to indicate absolute level of assurance expected to be provided by the practitioner on the subject matter. Absolute assurance indicates that a practitioner has performed procedures as considered appropriate to reduce the engagement risk to zero.

The increasing involvement of members in giving audit reports or certificates on special purpose statements or other information prepared by an enterprise necessitated the need for guidance to the auditor regarding various facets of such assignments including the form and contents of audit reports and certificates for special purposes. In view of this, the Institute brought out this Guidance Note on Audit Reports and Certificates for Special Purposes.

The following is an overview of the areas touched upon by the Guidance Note:

- ◆ Scope of special purpose reports and certificates
- ◆ Responsibility for preparation of special purpose statements
- ◆ Scope of the reporting auditor’s functions
- ◆ Contents of such reports and certificates
- ◆ Reports and certificates on specific items of financial statements
- ◆ Communication of report or certificate
- ◆ Communication with previous auditor.

The Guidance Note also contains examples of such reports and certificates.

1.6.3 Guidance Note on Tax Audit under Section 44AB of the Income-Tax Act

This Guidance Note was first issued by the Taxation Committee in 1985 and was revised from time to time by the Direct Taxes Committee. Refer to Chapter 15 for a detailed discussion.

1.6.4 Guidance Note on Audit of Inventories

The Guidance Note deals with procedures of the auditor in respect of audit of inventories. It outlines the peculiar features of inventories, which impact the audit procedures. The following is a gist of the important aspects of audit of inventories covered by the Guidance Note:

- ◆ *Internal Control Evaluation*: segregation of incompatible functions, standard form for recording movement of inventory, cross checking of data generated by different departments.
- ◆ *Verification*: management's responsibility for physical verification, sufficient appropriate audit evidence for existence, ownership and valuation, procedures for verification by auditor.
- ◆ *Examination of Records*: type of records, extent of auditor's examination, auditor's procedures in case of absence or insufficiency of records.
- ◆ *Attendance at Stock Taking*: need for auditor's attendance at stock taking, methods and procedures for stock taking, factors to be considered and procedures to be adopted in assessing the adequacy of stock taking, movement of stocks during stock taking, cut off procedures.
- ◆ *Confirmation from Third Parties*: factors to be seen, confirmations from third parties.
- ◆ *Examination of Valuation and Disclosures*: basis for valuation of inventories and methods of applying the basis, compliance with Accounting Standard (AS) 2, "Valuation of Inventories", use of standard costing, examination of the disclosure in financial statements.
- ◆ *Analytical Review Procedures*: illustrative analytical procedures, comprising mainly of comparison of various elements.
- ◆ *Work in Progress*: assessing appropriateness of its valuation etc.
- ◆ Management Representations.
- ◆ Documentation by the auditor.

The Guidance Note also gives illustrated set of instructions to be issued by the client to its staff responsible for stock taking, illustrative letter of confirmation of inventories held by others, illustrative letter of confirmation of inventories held by the entity on behalf of others and an illustrative management representation letter for inventories.

The Clarification issued by the Institute on the auditor's duties where inventories are stated to be "As Valued and Certified by the Management" in the financial statements, issued in September, 1999, has also been given.

1.6.5 Guidance Note on Audit of Debtors, Loans and Advances

The Guidance Note deals with the audit procedures that might be adopted by the auditor in case of audit of debtors, loans and advances. A gist of the relevant areas covered by the Guidance Note is as follows:

- ◆ *Internal Control Evaluation in Respect of Debtors:* fixing of credit/ loan/ advance limits, procedure for recording, realising and correlating outstandings from parties, aging schedule, periodic balance confirmation, authority for material adjustments to parties' account, periodic reconciliation statements, form and adequacy of security, recognition and realisation of interest income.
- ◆ *Verification:* audit evidence regarding existence, completeness, valuation and disclosure.
- ◆ *Examination of Records:* audit procedures for examining records.
- ◆ Indications of doubtful debts/ loans.
- ◆ *Direct Confirmation Procedures:* methods of obtaining confirmations, types of confirmations, timing of confirmations.
- ◆ *Analytical Review Procedures:* comparison of some important elements of debtors/loans and advances.
- ◆ Disclosure.
- ◆ Management Representations.
- ◆ Documentation.

The Guidance Note also contains an illustrative confirmation letters to be sent to debtors and management representation letter for debtors, loans and advances.

1.6.6 Guidance Note on Audit of Investments

This Guidance Note deals with the procedures that might be adopted by the auditor for auditing investments. The Guidance Note also throws light on the exceptional features of investments which have an impact on the audit procedures. The important aspects of audit of investments covered by the Guidance Note are highlighted as follows:

- ◆ *Internal Control Evaluation:* control over acquisition, accretion and disposal of investments, safeguarding of investments, controls in respect of title of investments, information controls.
- ◆ *Verification of Transactions:* authority to invest, legal requirements, supporting documents, terms of sale or purchase (ex or cum dividend/interest), rights issues, bonus issues.
- ◆ *Physical Verification:* responsibility of auditor, use of depository/ custodial services by the client, scripless trading, timing of physical examination, investments held by others, investments not held in the name of the client vis a vis legal requirements, procedure in finance/chit fund/nidhi companies etc., immovable properties held as investments.
- ◆ *Examination of Valuation or Disclosures:* valuation and disclosure of investments vis a vis, compliance with Accounting Standard (AS) 13 and statutory requirements, method of valuation.
- ◆ *Analytical Procedures:* comparison of various ratios.
- ◆ Management Representations.

1.12 Advanced Auditing and Professional Ethics

- ◆ Documentation by the auditor.

The Guidance Note, for the benefit of the members, also give a gist of legal requirements, including disclosure norms, relating to investments under certain prominent statutes, illustrative letter of confirmation for investments held by banks, and management representation letter for investments.

1.6.7 Guidance Note on Audit of Cash and Bank Balances

The Guidance Note deals with the audit procedures that might be adopted while auditing cash and bank balances. The following is a gist of the relevant areas covered by the Guidance Note:

- ◆ *Internal Control Evaluation*: segregation of incompatible functions, authorisation, recording of transactions, safe custody of cash, chequebooks etc., reconciliation statements, etc.
- ◆ *Verification of Cash Balances*: timing of carrying out verifications, procedure for verification, situations of unduly large cash balances, IOUs, procedures in case of discrepancies, frequency of verification.
- ◆ *Verification of Bank Balances*: procedures for verification, examination of bank reconciliation statements and unusually old outstandings therein, post dated cheques, obtaining confirmations from banks, inoperative bank accounts, fixed deposits, remittance in transit, treatment of stale cheques, valuation of foreign exchange transactions.
- ◆ *Examination of Valuation and Disclosure*: compliance with recognised accounting policies, practices, statutory requirements.

The Guidance Note also gives an illustrative letter of confirmation for bank balances.

1.6.8 Guidance Note on Audit of Liabilities

This Guidance Note contains recommended audit procedures in case of audit of liabilities. The following is an outline of the relevant areas discussed in the Guidance Note:

- ◆ *Internal Control Evaluation in Respect of Loans and Borrowings*: credit limits/borrowing powers and limits, authority, terms of borrowing, compliance with statutory requirements, variation in terms, security against loans, documentation, reporting of non compliance, balance confirmations, foreign exchange loans.
- ◆ *Internal Control Evaluation in Respect of Trade Creditors, Current Liabilities, Provisions, Trade Deposits*: in addition to those above, payment on duplicate invoices, schedule of creditors, adjustments to creditors, accounts to be authorised, cut off procedures.
- ◆ *Examination of Records of Loans and Borrowings*: validity and accuracy, agreement with the statements from creditors and loanees, loan agreements, change in the value of security, deferred payment credits.

- ◆ *Examination of Records of Trade Creditors and Other Current Liabilities:* cut off procedures, control accounts, documentary evidence, important aspects to be seen in the schedule of creditors etc., year end transactions, subsequent events.
- ◆ *Examination of Records of Provisions:* meaning of provision, objectives of audit of provisions, provision for taxes and duties, provision for gratuity, provision for bonus, provision for dividend, other provisions.
- ◆ *Examination of Records of Contingent Liabilities:* meaning, general procedures for verifying contingencies.
- ◆ *Direct Confirmation Procedures:* meaning, types – negative/ positive, suitability of each type, discrepancies in books of account vis a vis confirmations.
- ◆ *Examination of Disclosures.*
- ◆ *Analytical Review Procedures:* comparison of various ratios.
- ◆ *Special Considerations in case of a Company:* compliance with the relevant sections of the Companies Act.
- ◆ *Management Representations.*
- ◆ *Documentation.*

The Guidance Note also contains illustrative letter of confirmation to be sent to creditors and management representation letter for liabilities and contingencies.

1.6.9 Guidance Note on Audit of Revenue

The Guidance Note contains recommended audit procedures in case of audit of liabilities. The following is an outline of the areas covered by the Guidance Note:

- ◆ *Assertions Regarding Revenue:* occurrence, completeness, measurement, presentation and disclosure.
- ◆ Internal Control Evaluation.
- ◆ *Examination of Records:* compliance with AS 9, cut-off procedures, sales journal, dispatch documents, sales to intermediate parties, realisation in installments, export sales, revenue from services rendered.
- ◆ Examination of Presentation and Disclosure.
- ◆ *Analytical Procedures:* comparison of various relevant components of revenue.
- ◆ *Special Considerations in case of a Company:* compliance with relevant statutory requirements.
- ◆ Documentation.

1.6.10 Guidance Note on Audit of Expenses

This Guidance Note deals with the illustrative audit procedures that might be adopted by the auditors in auditing various items of expenses. The introductory part of the Guidance Note

1.14 Advanced Auditing and Professional Ethics

deals with the explanation of the term “expense” and the different approaches to identify the expense. It also deals with the peculiar features of “expenses” which impact the audit procedures as also the assertions to be examined in respect thereof.

The following is a gist of the relevant aspects of audit of expenses covered by the Guidance Note:

- ◆ Internal Control Evaluation
- ◆ Verification – Examining Records and Analytical Procedures
- ◆ Examination of Presentation and Disclosure
- ◆ Management Representation
- ◆ Documentation
- ◆ Special Considerations in the Case of a Company

The Guidance Note also contains illustrative audit procedures for the following items of expenses, viz., goods and raw materials consumed, purchases and purchase returns, wages and salaries, bonus, retirement benefits, other conversion costs, establishment and general administrative expenses, interest and financial charges, depreciation, research and development expenses, repairs and maintenance, contingencies, and taxes on income.

1.6.11 Guidance Note on Computer Assisted Audit Techniques (CAATs.)

Recognising the developments in the field of technology and its impact on the accounting profession in India, Auditing and Assurance Standards Board had issued Standard on Auditing (SA) 315, “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment” and SA 330, “The Auditor’s Responses to Assessed Risks”. The Guidance Note deals extensively, with the concept of CAATs and related pertinent issues such what CAATs are, where they may be used, considerations in use of CAATs, how to use CAATs, testing of CAATs, controlling application of CAATs, documentation required when using CAATs, use of CAATs in small entities, etc. The Guidance Note also contains a comprehensive appendix containing examples of CAATs, their description and comparable advantages and disadvantages of each of these CAATs.

1.6.12 Guidance Note on Audit of Payment of Dividends

The Auditing and Assurance Standards Board of India have issued the Guidance Note on Audit of Payment of dividend in order to keep the members abreast in resolving the technical intricacies involved in auditing payment of dividend. The Guidance Note deals, in detail, about internal control evaluation and various verification procedures required to be done by the auditor. The Guidance Note takes in to account both, corporate as well as non-corporate entities. The Appendix to the Guidance Note contains extracts of various relevant Acts and Rules relating to payment of dividend, the objective being to make the publication a complete, self-contained document for use by the members and others.

1.6.13 Guidance Note on Audit of Capital and Reserves

The Auditing and Assurance Standards Board of India has issued Guidance Note on Audit of Capital and Reserves in order to keep the members abreast in resolving the technical intricacies involved in auditing of capital and reserves. The Guidance Note discusses the auditing aspect of capital and reserves separately. It deals in detail, with different principle related aspects dealing with the audit of capital and reserves including implications of key legal requirements. This Guidance Note not only gives special consideration to companies but partnerships and sole proprietary concerns as well. The Guidance Note also incorporates circulars issued by the Government and other regulatory authorities wherever applicable.

The Guidance Note on Audit of Capital and Reserves discusses significant aspects of their audit such as evaluation of internal controls and verification, the audit evidence, the auditing procedure to be followed in case of issue of shares for consideration other than cash and in case of issue of Sweat Equity shares etc. The Guidance Note also deals with various types of reserves and their accounting treatment while discussing auditing aspects. It also lays down the documentation requirements for the audit of capital and reserves.

1.6.14 Guidance Note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013

This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) of the said sub-section creates a requirement for the auditor to consider observations or comments of the auditor on financial transactions or matters which have an adverse effect on the functioning of the company. Such observations or comments would ordinarily lead to the modification of or an emphasis of matter in the auditor's report on financial statements. It may be noted that the matters that lead to modification in the auditor's report on financial statements are matters that give rise to a qualified opinion, adverse opinion or a disclaimer of opinion. Further, matters that lead to an emphasis of matter paragraphs are matters appropriately presented or disclosed in the financial statements that, in the auditor's judgement, are of such importance that they are fundamental to the users' understanding of the financial statements. If the matter leading to the modification of the auditor's opinion or an emphasis of matter in the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to report such matter.

Under clause (h) of sub-section (3) of section 143 of the Act, the auditor is required to state whether any matter leading to a qualification, reservation or adverse remark, that is, effectively the modification of the auditor's report on financial statements, relates to the maintenance of accounts and other matters connected therewith.

1.6.15 Guidance Note on Audit of Consolidated Financial Statements(CFS)

An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or suo motu, might be required to or otherwise engage the auditor for conducting the audit of consolidated financial statements. However, a law or regulation governing the entity may require the consolidated financial statements

to be audited by the statutory auditor of the entity. This Guidance Note provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements. This Guidance Note can also be used while auditing consolidated financial statements prepared for special purpose, to the extent applicable. However, this Guidance Note does not deal with accounting matters arising on consolidation of financial statements. Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements. The formats for preparation of balance sheet, statement of profit and loss and a statement of change in equity (if applicable) are prescribed under the Schedule III of the Companies Act, 2013.

1.6.16 Guidance Note on CARO 2016

The purpose of this Guidance Note is to enable the members to comply with the reporting requirements of the Order. It should, however, be noted that the clarifications and explanations contained in this Guidance Note are not intended to be exhaustive and the auditors should exercise their professional judgment and experience on various matters on which they are required to report under the Order. Further, the Order is also not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein. Refer Chapter 8 Audit Reports and Auditing Pronouncements for details.

1.6.17 Guidance Note on Audit of Internal Financial Controls over Financial Reporting

To help the members properly understand and perform the various aspects of reporting responsibility related to audits of internal financial controls over financial reporting, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has brought out this Guidance Note on Audit of Internal Financial Controls Over Financial Reporting. The Guidance Note covers aspects such as Scope of reporting on internal financial controls under Companies Act 2013, essential components of internal financial controls, Technical guidance on audit of internal financial controls, Implementation guidance on audit of internal financial controls.

The Companies Act, 2013 has introduced some new requirements relating to audits and reporting by the statutory auditors of companies. One of these requirements is given under Section 143(3)(i) of the Act which requires the statutory auditor to state in his audit report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The section has cast onerous responsibilities on the statutory auditors because reporting on internal financial controls is not covered under the Standards on Auditing issued by the ICAI. Student may refer Handbook on Auditing Pronouncements for more details.

1.6.18 Guidance Note on Reporting on Fraud under section 143(12) of the Companies Act, 2013

This guidance note deals with section 143(12) of the Companies Act, 2013 which states that "Notwithstanding anything contained in this section, if an auditor of a company, in the

course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

It is also provided that in case of fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed: It also provide guidance that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed." Student may refer Handbook on Auditing Pronouncements for more details.

1.7 Guidance note(s) on Related Services

The framework for auditing and related services makes it clear that there can be different layers of assurance depending upon the nature of services being performed by the chartered accountant. Related Services comprise of Review engagements, Agreed upon Procedures and Compilation Engagement. Reviews engagements involve providing moderate assurance (or negative assurance) but other two services, viz., and compilation and agreed upon procedures provide no assurance at all. The Institute has issued guidance notes covering these aspects of related services in a comprehensive manner.

1.8 Authority Attached to the Documents Issued by the Institute/MCA

The Institute has, from time to time, issued 'Statements' and 'Guidance Notes' on a number of matters. With the formation of the Accounting Standards Board and the Auditing and Assurance Standards Board, Accounting Standards and *Standards on Auditing* have also been issued. The level of authority attached to these documents and the degree of compliance required in respect thereof has been explained by the Institute through its various announcements issued from time to time.

1.8.1 Statements

The 'statements' have been issued with a view to securing compliance by members on matters which in the opinion of the council of the institute are critical for the proper discharge of their functions. 'statements' therefore are mandatory. Accordingly, while discharging their attest function, it is the duty of the members of the institute.

- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from such 'Statements', it is their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and
- (b) to ensure that the 'Statements' relating to auditing matters, are followed in the audit of financial information covered by their audit reports. If, for any reason, a member, has not been able to perform an audit in accordance with such 'Statements' his report should

1.18 Advanced Auditing and Professional Ethics

draw attention to the material departures there from.

1.8.2 Guidance Notes

'guidance notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary. There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as **mandatory** on members while discharging their **attest** function.

1.8.3 Accounting Standards and Standards on Auditing

The 'accounting standards' and '*Standards on Auditing*' establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards and that auditors carry out their audit in accordance with the generally accepted auditing practices. They become mandatory on the dates specified in the respective document or notified by the council.

There can be situations in which certain matters are covered both by a 'Statement' and by an 'Accounting Standard'/'*Standards on Auditing*'. In such a situation, the 'Statement' prevails till the time the relevant 'Accounting Standard'/'*Standards on Auditing*' becomes mandatory. Once an 'Accounting Standard'/'*Standards on Auditing*' becomes mandatory, the concerned 'Statement' or the relevant part thereof automatically stands withdrawn.

Standards on Auditing (SAs) establish standards, which have to be complied with to ensure that auditors carry out their duties in accordance with the generally accepted auditing practices. They become operative (i.e., mandatory) in respect of audit of all enterprises on the dates specified in the respective SAs or notified by the Council. The duties of the members of the Institute in relation to operative SAs are similar to those in respect of 'Statements' relating to auditing matters.

1.8.4 Accounting Standards

Accounting Standards are formulated by the Accounting Standards Board and issued by the Council of the Institute. The Accounting Standards are issued for use in the presentation of 'general purpose financial statements' which are issued to the public by such 'commercial, industrial or business enterprises' as may be specified by the Institute from time to time and subject to the attest function of its members. They become mandatory on the dates specified in the respective Accounting Standards or notified by the Council in this behalf.

- (a) The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof,

issued for the use of shareholders/members, creditors, employees and public at large.

- (b) The reference to 'commercial, industrial or business enterprises' is in the context of the nature of activities carried on by an enterprise rather than with reference to its objects. The Accounting Standards apply in respect of commercial, industrial or business activities of any enterprise, irrespective of whether it is profit oriented or is established for charitable or religious purposes. Accounting Standards will not, however, apply to those activities which are not of commercial, industrial or business nature (e.g. an activity of collecting donations and giving them to flood affected people). The exclusion of an entity from the applicability of the Accounting Standards is permissible only if no part of the activity of entity is commercial, industrial or business in nature. In other words, even if a very small proportion of the activities of an entity is considered to be commercial, industrial or business in nature, then it cannot claim exemption from the application of Accounting Standards. In such a case the Accounting Standards will apply to all its activities including those which are not commercial, industrial or business in nature.

The Companies Act as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view.

The 'Preface to the Statements of Accounting Standards' issued by the Institute in 2004 states (paragraphs 6.1 and 6.3):

"6.1 While discharging their attest function, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their reports so that the users of such statements may be aware of financial deviations."

"6.3 Financial Statements cannot be described as complying with the Accounting Standards unless they comply with all the requirements of each applicable standard."

Once an Accounting Standard becomes mandatory, the duties of an auditor with respect to such standard are the same as those specified at paragraph 2(a) above.

While discharging their attest function, the members of the Institute may keep the following in mind with regard to mandatory Accounting Standards.

AS 1 - Disclosure of Accounting Policies - In the case of a company, members should qualify their audit reports in case:

- (a) accounting policies required to be disclosed under Schedule III or any other provisions of

1.20 Advanced Auditing and Professional Ethics

- the Companies Act, 2013, have not been disclosed, or
- (b) accounts have not been prepared on accrual basis, or
 - (c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
 - (d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated in paragraph 16 above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

If accounting policies have not been disclosed at one place or if certain significant accounting policies have not been disclosed, by a company on the ground that their disclosure is not required under the Companies Act, 2013, the member should disclose the fact in his audit report without necessarily making it a subject matter of audit qualification. Such a disclosure would not constitute a reservation, qualification or adverse remark except where the auditor has specifically made it a subject matter of audit qualification. Accordingly in the case of a company, the Board of Directors need not provide information or explanation with regard to such a disclosure (except where the same constitutes a qualification) in their report under sub-section (3) of Section 134 of the Companies Act, 2013.

In the case of enterprises not governed by the Companies Act, 2013, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary. In the event of non-compliance, by enterprises not governed by the Companies Act, 2013, with the disclosure requirements of AS1 in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

Other Mandatory Accounting Standards - While making a qualification, the auditor should follow the requirements of the 'Statement on Qualifications in Auditor's Report' issued by the Institute. Subject to this, non-compliance with any of the requirements of a mandatory Accounting Standard other than AS 1 by any enterprise should be a subject matter of qualification except that, to the extent that the disclosure requirements in the relevant standard are in addition to the requirements of the Companies Act, 2013, or any other applicable statute, the member should disclose the fact of non-compliance with such disclosure requirements in his audit report without necessarily making it a subject matter of audit qualifications.

Financial Statements Prepared on a Basis other than Accrual - With regard to the fundamental accounting assumption of accrual, the Council of the Institute has made a

specific announcement that in respect of individuals/bodies covered by para AS 1 - *Disclosure of Accounting Policies* above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no statutory requirement for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual', the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/qualifications in his audit report accordingly.

1.8.5 Ind AS

Indian Accounting Standards (Ind-AS) are the International Financial Reporting Standards (IFRS) converged standards issued by the Central Government of India under the supervision and control of Accounting Standards Board (ASB) of ICAI and in consultation with National Advisory Committee on Accounting Standards (NACAS). The Ind AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS).

In July 2014, the Finance Minister of India at that time, Shri Arun Jaitely ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the International Financial Reporting Standards (IFRS) through adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies from the financial year 2015-16 voluntarily and from the financial year 2016-17 on a mandatory basis.

Pursuant to the above announcement, various steps have been taken to facilitate the implementation of IFRS-converged Indian Accounting Standards (Ind AS). Moving in this direction, the Ministry of Corporate Affairs (MCA) has issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Indian Accounting Standards (Ind AS). As per the Notification, Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) shall be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016.

Manner of Making Qualification Disclosure in the Audit Report - In making a qualification/disclosure in the audit report in respect of non-compliance with a Statement, SA, Accounting Standard or Guidance Note, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification/disclosure in respect of items which, in his judgement, are not material.

1.22 Advanced Auditing and Professional Ethics

While making a qualification, the auditor should follow the requirements of the 'Statement on Qualifications in Auditor's Report' issued by the Institute.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

Examples of Qualifications/Disclosures in the Audit Report - Given below are some examples which illustrate the manner of making qualification/disclosure in the audit report. It may be clarified that these examples are aimed only at illustrating the manner of making qualifications/disclosures and are not intended in any way to be exhaustive.

Examples of Qualifications

- (a) Where proper disclosures regarding changes in accounting policies have not been made by a company.

"The statement of profit and loss and balance sheet comply with the accounting standards referred to Section 133 of the Companies Act, 2013, except Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', as the company has not disclosed in its accounts the fact of change, from this year, in the method of providing depreciation on plant and machinery from straight-line method to written-down value method, as also the effect of this change. As a result of this change, the net profit for the year, the net block as well as the reserves and surplus are lower by ₹ Each as compared to the position which would have prevailed had this change not been made.

Subject to the above, we report that"

- (b) Where a manufacturing company has accounted for interest income on receipt basis and not on time proportion basis.

"The statement of profit and loss and balance sheet comply with the accounting standards referred to in Section 133 of the Companies Act, 2013, except Accounting Standard (AS) 9, 'Revenue Recognitions', as the company has followed the policy of accounting for interest income on receipt basis rather than on time proportion basis. As a result, the net profit for the year and the current assets are understated by ₹..... each as compared to the position which would have prevailed if the company had accounted for interest income on time proportion basis.

Subject to the above, we report that"

- (c) Where an enterprise has capitalised financing costs related to certain fixed assets for periods after such assets were ready to be put to use.

"The statement of profit and loss and balance sheet comply with the accounting standards referred to in Section 133 of the Companies Act, 2013, except Accounting Standard (AS) 16, 'Borrowing Costs', as interest payable on borrowings related to the

acquisition of fixed assets has been capitalised for the periods after which the assets were put to use. Consequently, the net profit for the year, the net block of fixed assets and the reserves and surplus have been overstated by ₹..... each as compared to the position which would have prevailed if the company had complied with the requirements of AS 16.

Subject to the above, we report that"

Examples of Disclosures

- (a) Where a company has not disclosed all significant accounting policies and has also not disclosed the accounting policies at one place.

"The statement of profit and loss and balance sheet comply with the accounting standards referred to in Section 133 of the Companies Act, 2013, except Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', as the company has disclosed those accounting policies the disclosure of which is required by the Companies Act, 2013. Other significant accounting policies, relating to treatment of research and development costs have not been disclosed nor have all the policies been disclosed at one place.

We report that"

- (b) Where a sole proprietary concern enterprise follows cash basis of accounting.

"It is the policy of the enterprise to prepare its financial statements on the cash receipts and disbursements basis. On this basis revenue and the related assets are recognised when received rather than when earned, and expenses are recognised when paid rather than when the obligation is incurred.

In our opinion, the financial statements give a true and fair view of the assets and liabilities arising from cash transactions of at and of the revenue collected and expenses paid during the year then ended on the cash receipts and disbursements basis as described in Note X."

Applicability of Accounting Standards to charitable and/or religious organisations - The Accounting Standards Board has received a query as to whether the accounting standards formulated by it are applicable to organisations whose objects are charitable or religious. The Board has considered this query and its views in the matter are set forth in the following paragraphs.

The Preface to the Statements of Accounting Standards states:

"The Institute will issue Accounting Standards for use in the presentation of the general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members".

The reference to commercial, industrial or business enterprises in the aforesaid paragraph is in the context of the nature of activities carried on by an enterprise rather than with reference to its objects. It is quite possible that an enterprise has charitable objects but it carries on,

1.24 Advanced Auditing and Professional Ethics

either wholly or in part, activities of a commercial, industrial or business nature in furtherance of its objects. The Board believes that Accounting Standards apply in respect of commercial, industrial or business activities of any enterprise, irrespective of whether it is profit oriented or is established for charitable or religious purposes. Accounting Standards will not, however, apply to those activities which are not of a commercial, industrial or business nature. (e.g. an activity of collecting donations and giving them to flood affected people).

It is also clarified that exclusion of an entity from the applicability of the Accounting Standards would be permissible only if no part of the activity of such entity was commercial, industrial or business in nature. For the removal of doubts, it is clarified that even if a very small proportion of the activities of an entity were considered to be commercial, industrial or business in nature, then it could not claim exemption from the application of Accounting Standards. The Accounting standards would apply to all its activities including those which were not commercial, industrial or business in nature.

2

Audit Strategy, Planning and Programming

2.1 Commencing an Audit

SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing” states that to achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit. Without a careful plan, the overall objective of an audit may not be achieved. The audit planning is necessary to conduct an effective audit in an efficient and timely manner.

2.1.1 Benefits/Advantages of Planning in an Audit of Financial Statements

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways described hereunder-

- (i) Attention to Important Areas - Planning would help the auditor to devote appropriate attention to important areas of the audit.
- (ii) Timely resolution of Potential Problems - It would also help the auditor identify and resolve potential problems on a timely basis.
- (iii) Proper Organisation and Management of Audit Engagement - Adequate planning would help the auditor in properly organizing and managing the audit engagement so that it is performed in an effective and efficient manner.
- (iv) Proper Selection of Engagement Team - Planning would assist the auditor in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- (v) Direction and Supervision of Engagement Team - It would further facilitate the direction and supervision of engagement team members and the review of their work.
- (vi) Easy Coordination - Also, planning would be helpful to the auditor in coordination of work done by auditors of components and experts.

2.1.2 Nature and Extent of Planning

So far as the nature of planning is concerned, it would vary according to-

- (i) Size and Complexity of the Auditee - If the size and complexity of organization of which audit is to be conducted is large, then much more planning activities would be required as compared to an entity whose size and complexity is small.

2.2 Advanced Auditing and Professional Ethics

- (ii) Past Experience - The key engagement team members' previous experience also contributes towards variation in planning activities.
- (iii) Change in Circumstances - Another factor contributing towards variation in planning activities is change in circumstances.

2.1.3 Planning - A Continuous Process

Planning is not a discrete phase of an audit but rather a continual and iterative process. It often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes consideration of the timing of certain activities and audit procedures.

For example, planning includes the need to consider such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

2.1.4 Overall Audit Strategy and Audit Plan - Responsibility of the Auditor

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. For example - to coordinate some of the planned audit procedures with the work of the entity's personnel.

Although these discussions often occur but the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters about the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For Example - discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

The engagement partner and other key members of the engagement team shall be involved in planning the audit. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience thereby enhancing the effectiveness and efficiency of the planning process.

2.1.5 Preliminary Engagement Activities

The auditor shall undertake the following activities at the beginning of the current audit engagement-

- (i) Performing procedures required by SA 220, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement.

As per the combined reading of SA 220 and SQC 1, information and procedures such as the following assists the auditor in determining whether the conclusions reached regarding

the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures.

- (ii) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and
- (iii) Establishing an understanding of the terms of the engagement, as required by SA 210.

2.1.6 Contents of an Audit Plan

The auditor shall develop an audit plan that shall include a description of-

- (i) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
- (ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
- (iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

2.1.7 Changes to Planning Decisions

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

2.4 Advanced Auditing and Professional Ethics

The auditor may need to modify the overall audit strategy and audit plan due to below mentioned factors-

- (i) result of unexpected events,
- (ii) changes in conditions, or
- (iii) the audit evidence obtained from the results of audit procedures.

Further, the auditor would also modify the nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

This may be the case when information coming to the auditor differs significantly from the information when he planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

2.2 Overall Audit Strategy

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

2.2.1 Factors while establishing Overall Audit Strategy

Overall audit strategy would involve-

- (i) Determination of Characteristics of Audit: Identify the characteristics of the engagement that define its scope.
- (ii) Reporting Objectives: Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.
- (iii) Team's Efforts: Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- (iv) Preliminary Work: Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.
- (v) Nature, timing and Resources: Ascertain the nature, timing and extent of resources necessary to perform the engagement.

2.2.2 Benefits of Overall Audit Strategy

The process of establishing the overall audit strategy assists the auditor to determine such matters as-

- (i) Employment of Qualitative Resources: The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters.
- (ii) Allocation of Quantity of Resources: The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at

material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.

- (iii) **Timing of Deployment of Resources:** When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates.
- (iv) **Management of Resources:** How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

2.2.3 Considerations in Establishing the Overall Audit Strategy

Some of the examples of matters that the auditor may consider in establishing the overall audit strategy are given hereunder. Many of these matters will also influence the auditor's detailed audit plan. All matters are not relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- (i) The financial reporting framework.
- (ii) Industry-specific reporting requirements such as reports mandated by industry regulators.
- (iii) The expected audit coverage, including the number and locations of components to be included.
- (iv) The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- (v) The extent to which components are audited by other auditors.
- (vi) The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- (vii) The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- (viii) The effect of information technology on the audit procedures.
- (ix) The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications

- (i) The entity's timetable for reporting.
- (ii) The organization of meetings with management regarding audit work (Nature, timing and extent).
- (iii) The discussion with management regarding type and timing of reports to be issued.
- (iv) The discussion with management regarding communications on the status of audit work.
- (v) Communication with auditors of components regarding types and timing of reports to be issued.

2.6 Advanced Auditing and Professional Ethics

- (vi) The nature and timing of communications among engagement team members.
- (vii) Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- (i) The determination of materiality in accordance with SA 320.
- (ii) Preliminary identification of areas where there may be a higher risk of material misstatement.
- (iii) The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- (iv) The manner in which engagement team members need to maintain a questioning mind and to exercise professional skepticism.
- (v) Results of previous audits including the identified deficiencies and action taken to address them.
- (vi) The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- (vii) Evidence of management's commitment to the design, implementation and maintenance of sound internal control.
- (viii) Volume of transactions which may determine reliance on internal control.
- (ix) Importance attached to internal control.
- (x) Significant business developments affecting the entity.
- (xi) Significant industry developments.
- (xii) Significant changes in the financial reporting framework, such as changes in accounting standards.
- (xiii) Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- (i) The selection of the engagement team and the assignment of audit work to the team members.
- (ii) Engagement budgeting.

2.2.4 Documenting the Audit Plan

The auditor shall document-

- (i) The overall audit strategy;
- (ii) The audit plan; and
- (iii) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes as under-

- (a) **Record of Key Decisions:** The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.
- (b) **Record of Nature, Timing and Extent of Risk Assessment Procedures:** The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.
- (c) **Record of reasons for Change in Audit Plans:** A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

2.2.5 Relationship between the Overall Audit Strategy and the Audit Plan



Fig 1: Audit Strategy and the Audit Plan are interrelated.*

The audit strategy is prepared before the audit plan. The audit plan contains more details than the overall audit strategy. Audit strategy and audit plan are inter-related because change in one would result into change in the other. The audit strategy provides the guidelines for developing the audit plan. It establishes the scope and conduct of the audit procedures and thereby works as basis for developing a detailed audit plan. Detailed audit plan would include the nature, timing and extent of the audit procedures so as to obtain sufficient appropriate audit evidence.

* Source : *m-sp-c.com*

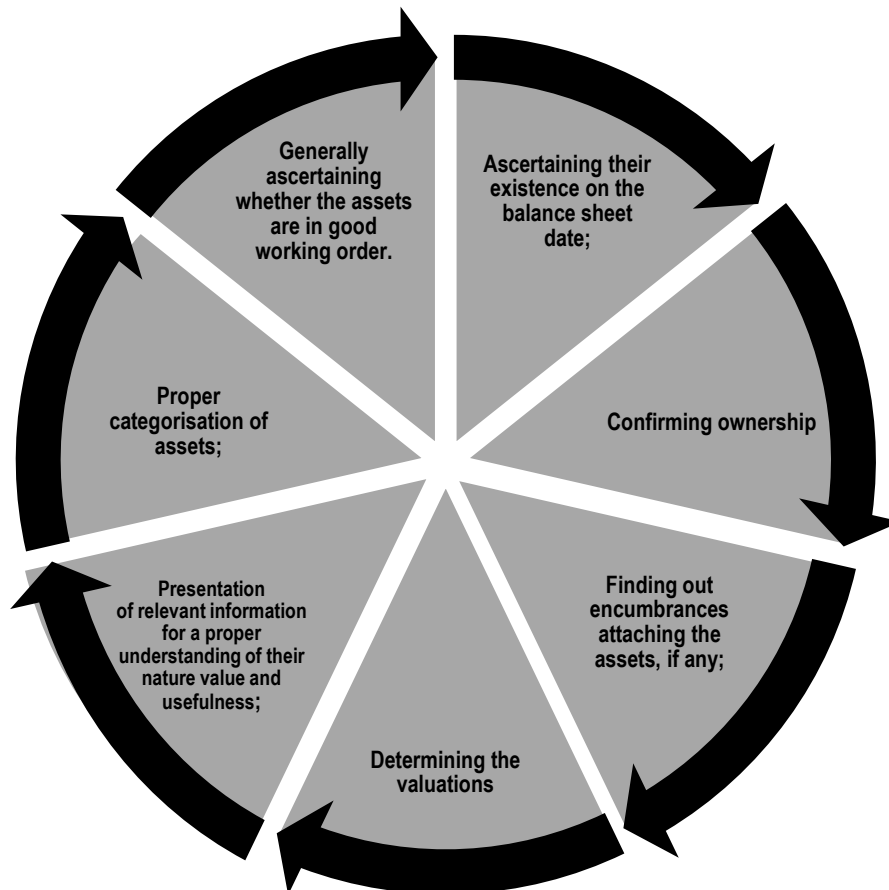
Example

CA. Sapna has already developed an audit strategy for Hitesh Ltd. While a detailed audit plan is being developed, she decided that materiality levels set earlier need to be increased as weaknesses in the internal controls were highlighted in the internal audit report. Subsequently, a deviation from the audit strategy is felt necessary. Therefore, Sapna would firstly modify the overall strategy and thereafter prepare the audit plan according to the strategy. This shows that the audit strategy and audit plan are closely inter-related as change in one is resulting into change in the other.

2.3 Audit Programme

In I(IPC) study material, we have discussed audit programme generally so as to enable the students to know the utility and nature of audit programmes. An audit programme is commonly prepared to allocate work to team members which may include the list of audit procedures and instructions to be followed by the member. It also estimates the duration for completing an audit task.

2.3.1 Formulating an Audit Programme



It is very useful for students to know how to plan an audit programme. The programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of work. It may be emphasised that a clear spelling out of audit objectives for each area is important to link up the procedures with audit objectives and to ensure a purposeful audit. For example, in the area of fixed assets, audit objectives can be the following:

Procedures of verification for this purpose may include physical verification, review of working papers, document verification including verification of loan documents, checking of provisions for depreciation, review of accounting policy on fixed assets, verification of compliance with legal requirements about disclosure and verification of jobs work performed by the assets. This linkage in the mind of the assistants on job is imperative and without this the audit would be just a mechanical performance. They should be able to identify the assertions made in the Balance Sheet and Profit and Loss Account because that provides key to the auditor's selection of the procedures. The important matters which need to be considered in this regard are:

(a) Nature of business in which the organisation is engaged: On his first appointment, the auditor should examine in detail the financial and accounting organisation of the business by visiting the client's office; by observing different stages through which papers pass before each transaction is authorised and recorded; the record that is kept and the titles of books in which it is kept. In the case of an industrial concern, he must also visit the factory to acquaint himself with the different processes of manufacture, the quantitative records maintained and the manner in which statistics are compiled in respect of losses in process.

The nature of business carried on by the concern has a great relevance to different audit procedures. The auditor, therefore, should draw up the programme of audit on a consideration of the technical, financial and accounting set-up of the company.

(b) Overall plan: Overall plan for the audit programme should be drawn up to ensure a systematic approach to the work. If in drawing the audit programme, any divergence from the overall plan becomes necessary, first the overall plan should be modified after due consideration and thereafter only the matter may be taken in the audit programme. The frame provided by the overall plan should be strictly adhered to.

(c) System of internal control and accounting procedures: The existence of a system of internal control is essential for every business organisation. It ensures that both financial and statistical records are checked continuously; it also unearths errors, both of omission and of commission. The auditor, in framing his opinion on financial statements needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that transactions have not been omitted. Internal control may contribute to the reasonable assurance the auditor seeks. Therefore, it has become an accepted audit practice to study and evaluate internal control. The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal control in determining the nature, timing and extent of his substantive auditing procedures. The auditor also obtains an understanding of the accounting system to identify points in processing of transaction and handling of assets where errors or fraud may occur. When the auditor relies on internal control, it is at these points that he must be satisfied that internal control procedures applied by the entity are effective for his

2.10 Advanced Auditing and Professional Ethics

purpose.

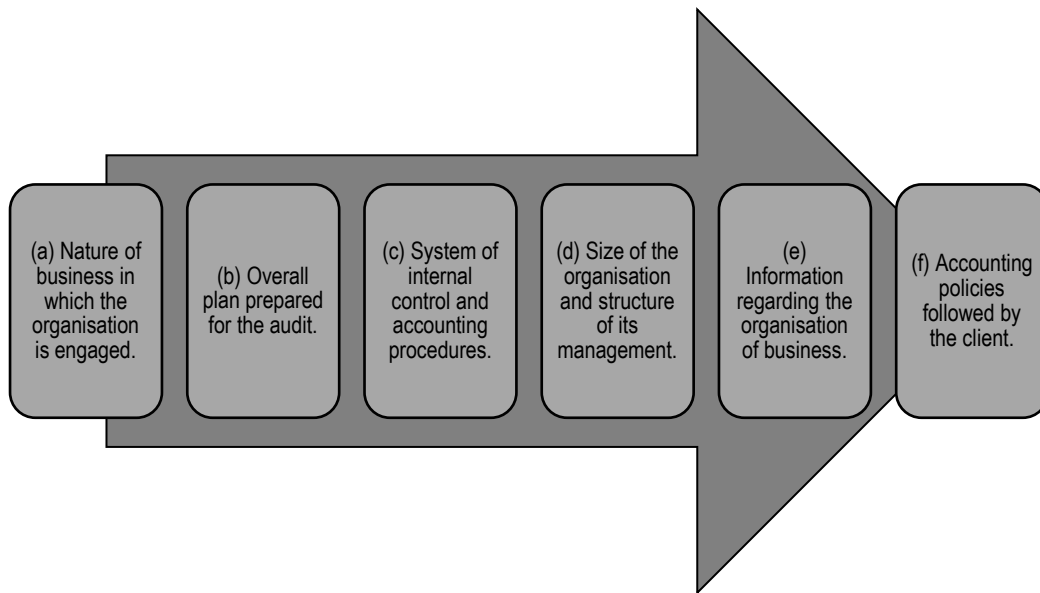
The auditor's examination of the system of internal control should have three features - review and preliminary evaluation, testing of compliance and evaluation.

- (i) **Review and preliminary evaluation** - The auditor should review the accounting system and related internal control to gain an understanding of the flow of transactions and the specific control procedures to be able to make a preliminary evaluation and identification of these aspects of internal control on which it might be efficient and effective to rely in conducting his audit.
 - (ii) **Test of compliance** - Compliance tests should be conducted by the auditor to gain evidence that those internal controls on which he intends to rely operate generally as identified by him and that they function effectively throughout the period of intended reliance. Based on the results of his compliance procedure including observed deviations, the auditor should evaluate whether the internal controls are adequate for his purposes.
 - (iii) **Evaluation** - It is essentially an objective process of application of auditor's judgement to determine whether all or any of the internal controls in the client's organisation can be relied upon in carrying out the audit. Based on the degree of reliance which may be full, partial or none, the auditor will programme for the substantive verification of transactions for expression of audit opinion. The results of compliance procedure directly provide the basis for this evaluation and, in turn, basis to determine the nature, timing and extent of the substantive audit procedure. In evaluating the auditor recognises that some deviations from compliance may have occurred.
- (d) **Size of the organisation and structure of its management:** An increase in the size of the organisation enhances the complexity of the examination of its accounting records specially when it has a number of branches, deals in several products or has a very large turnover. With the increase in the size ordinarily the scope and extent of the system of internal control also should increase but it may not be so in every case. It has been the experience that while many small businesses have excellent controls, some of the large enterprises are deficient in their operational controls. For example, the reports of the Comptroller and Auditor General on audit of accounts of Public Enterprises show that some of them have a very poor system of internal control. In such cases, the magnitude of the tasks of the auditor increases considerably.
- (e) **Information as regards organisation of the business:** To plan audit programme, it is necessary that the auditor should obtain from his client information as regards the under mentioned matters-
- ◆ Client's history and business.
 - ◆ Purpose and nature of engagement.
 - ◆ Time schedule for the completion of audit.

Before accepting a new audit, the auditor should satisfy himself as to the desirability of being associated with the job. If the concern is not known to him, he should enquire into its standing, financial background, nature of business and other similar matters. As far as practicable, he

should also try to ascertain the reputation of the concern as also the honesty and integrity of principal executive.

(f) Accounting and management policies: On the first appointment it is necessary that the auditor should review the financial statements of the past several years, audited by his predecessors specially those of the immediately preceding previous year. This would reveal to him a great deal of information regarding accounting and management policies which have been followed in the past and whether these have been employed consistently.



2.3.2 Drawing up the audit programme

After the auditor has collected the aforementioned information, he will be in a position to draw up the programme of audit. He can now decide the areas to be covered by audit, also those to be covered in detail and those which should be covered by the applications of the test checks. He will also be able to decide the specific audit procedures which should be applied in each case. These procedures vary widely because of the conditions under which each concern operates, its form of organisation, its nature of business and the condition of its accounts. On this account, it is not practicable to draw up a typical audit programme. When an auditor is appointed to audit the accounts of an entity for the first time, the audit programme should be developed in three stages stated below:

- (i) To begin with, a broad outline of the audit programme should be drawn up.
- (ii) After the internal and accounting procedures have been reviewed, the details should be filled up on a consideration of the deficiencies in the system of internal control.
- (iii) After the detailed checking formality is over, the extent to which the special procedures need to be applied should be determined, e.g., independent verification of balances of

2.12 Advanced Auditing and Professional Ethics

debtors and creditors, physical inspection of fixed assets, personal inspection of various items of stock included in closing inventories and testing their values. At times, special procedures may have to be applied on a consideration of the nature of business e.g. verification of provision for tax liability in case of a shipping company regarding freight booked in different countries or for making a provision for unexpired liability in case of an insurance company, etc.

At each subsequent engagement the programme should be reviewed and, if necessary, modified on account of:

- (i) experience gained during the previous audits;
- (ii) important changes that have taken place in the business specially in the system of internal control, accounting procedures or in the structure of management or of the scope of business; and
- (iii) evaluation of internal control made for the current year.

Given below are a few circumstances where in the audit programme would have to be suitably altered:

- (1) If the audit procedures were designed for a certain volume of turnover and subsequently the volume have substantially increased. Also, when there have been significant changes in the accounting organisation, procedures and personnel subsequent to the audit procedures.
- (2) Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.
- (3) Where there has been an extraordinary increase in the amount of book debts or that in the value of stocks as compared to that in the previous year.
- (4) When a suspicion is aroused during the course of audit or information has been received that assets of the company have been misappropriated.

It may be noted that the audit plan and related programme should be reconsidered as the audit progresses. Such re-consideration is based on the auditor's review of internal control, his preliminary evaluation thereof and the result of his compliance and substantive procedures.

Risk Assessment and Internal Control

3.1 Introduction

Internal Controls and Risk Assessment

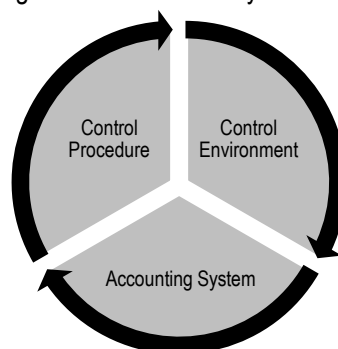


Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Fig.: Internal Control and Risk Assessment*

An auditor may consider audit risk both at overall level as well as at the level of individual account balances or classes of transactions. This means that at overall level the auditor applies their professional judgement to determine the extent of risk which he considers to be an acceptable level. At account balance level, audit risk refers to the risk that error in monetary terms exists beyond a tolerable error limit in the account balances or class of transaction which the auditor fails to detect.

The Internal Control structure in an organization is referred to as the policies and procedures established by the entity to provide reasonable assurance that the objectives are achieved. The control structure in an organization basically has the following components:



- 1. Control Environment** - Control environment covers the effect of various factors like management attitude; awareness and actions for establishing, enhancing or mitigating the effectiveness of specific policies and procedures.

* Source : SlideShare

3.2 Advanced Auditing and Professional Ethics

2. Accounting System - Accounting system means the series of task and records of an entity by which transactions are processed for maintaining financial records. Such system identifies, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

3. Control Procedure - Policies and procedures means those policies and procedures in addition to the control environment and accounting systems which the management has established to achieve the entity's specific objectives.

In this regard, the management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent that they are appropriate to the size and nature of the business. There should be reasonable assurance for the auditor that the accounting system is adequate and that all the accounting information required to be recorded has in fact been recorded. Internal controls normally contribute to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, he could reduce his substantive procedures which otherwise may be required and may also differ as to the nature and timing.

Specific Requirement under **SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"** deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control. SA 315 defines the system of internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. SA 315 further states that the auditor should identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

3.2 Internal Control System - Nature, Scope, Objectives and Structure

Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

The Following are the Nature, Scope, Objectives and Structure of an Internal Control Audit:

Nature - A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisations efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of the business entity.

SA 315 defines the system of internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

Internal control is a process/set of processes designed to facilitate and support the achievement of business objectives. Any system of internal control is based on a consideration of significant risks in operations, compliance and financial reporting. Objectives such as improving business effectiveness are included, as are compliance and reporting objectives.

Scope - The scope of internal controls extends beyond mere accounting controls and includes all administrative controls concerned with the decision - making process leading to managements authorization of transaction, such controls include, production method, time and motion study, pricing policies, quality control, work standard, budgetary control, policy appraisal, quantitative controls etc. In an independent financial audit, the auditor is primarily concerned with those policies and procedures having a bearing on the assertions underlying the financial statements. These comprise primarily controls relating to safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records and timely preparation of reliable financial information. Administrative controls, on the other hand, have only a remote relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the reliability of the financial records.

The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

An internal control system:

3.4 Advanced Auditing and Professional Ethics

- ***Facilitates the effectiveness and efficiency of operations.***
- ***Helps ensure the reliability of internal and external financial reporting.***
- ***Assists compliance with laws and regulations.***
- ***Helps safeguarding the assets of the entity.***

Objectives - The objectives of internal control systems are determined by the management, after considering the nature of business, scale operations, the extent of professionalism of the management etc. The objectives of internal controls relating to the accounting system are:

- (i) Transactions are executed through general or specific management authorization.
- (ii) All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets.
- (iii) Assets and records are safeguarded from unauthorized access, use or disposition.
- (iv) Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies.

Precisely, the control objectives ensure that the transactions processed are complete, valid and accurate. The basic accounting control objectives which are sought to be achieved by any accounting control system are:

- (a) whether all transactions are RECORDED;
- (b) Whether recorded transactions are REAL;
- (c) whether all recorded transactions are PROPERLY VALUED;
- (d) whether all transactions are RECORDED TIMELY;
- (e) whether all transactions are PROPERLY POSTED;
- (f) whether all transactions are PROPERLY CLASSIFIED AND DISCLOSED;
- (g) whether all transactions are PROPERLY SUMMARIZED.

If the response to all the above answer is positive, the auditor would be justified in limiting his account balance tests considerably. In case of excellent companies it may also be possible to rely on account balance with minimum of external tests, such as direct confirmation, management representation etc. Where in a system a particular control is found to be deficient, audit attention can be focused on the areas where basic accounting control objectives are not being adhered to. For example, if it found that sales transactions are not being properly valued in accordance with the price list determined by the management, the auditor would have to perform extensive searching tests on sales invoices to assure himself that the recoverable amounts are correctly posted. He may also want to expand his confirmation request at the year end to cover a large majority of trade receivables.

Limitations of Internal Control -

Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial

reporting and compliance objectives. Internal control systems are subject to certain inherent limitations, such as:

- *Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.*
- *The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.*
- *The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.*
- *The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.*
- *Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.*

Structure - In order to achieve the objectives of internal controls, it is necessary to establish adequate control policies and procedures. Most of these policies and procedures cover:

Segregation of duties - Transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person. The purpose is to minimize the occurrence of fraud and errors and to detect them on a timely basis, when they take place. The following functions are segregated -

- (a) authorization of transactions;
- (b) execution of transactions;
- (c) physical custody of related assets; and
- (d) maintenance of records and documents, while allocating duties, the considerations of cost and efficacy should be kept in mind as there is a tendency to stretch the allocation of tasks involved in a job to more persons than what is required resulting in cumbersome procedures, over elaboration of records and unduly high cost of administration.

Apart from segregation of duties, periodic rotation of duties of personnel is also desirable. The rotation of duties seeks to ensure that if a fraud and error is committed by a person, it does not remain undetected for long. It also ensures that a person cannot develop vested interest by holding a position for too long. Rotation of duties also ensures that each employee keeps his work up to date. This also makes an employee to be careful because he is aware that his performed tasks will be reviewed by others when duties are rotated.

Authorization of Transaction - Delegation of authority to different levels and to particular persons are required to establish by the management for controlling the execution of transaction in accordance with prescribed conditions. Authorization may be general or it may be specific with reference to a single transaction. It is necessary to establish procedures which provide assurance that authorizations are issued by persons acting within the scope of their

3.6 Advanced Auditing and Professional Ethics

authority, and that the transactions conform to the terms of the authorizations. This objective can be achieved by making independent comparison of transaction document with general or specific authorizations, as the case may be.

Adequacy of Records and Documents - Accounting controls should ensure that -

- (i) Transactions are executed in accordance with management's general or specific authorization.
- (ii) Transactions and other events are promptly recorded at correct amounts.
- (iii) Transactions should be classified in appropriate accounts and in the appropriate period to which it relates.
- (iv) Transaction should be recorded in a manner so as to facilitate preparation of financial statements in accordance with applicable accounting standards, other accounting policies and practices and relevant statutory requirements.
- (v) Recording of transaction should facilitate maintaining accountability for assets.
- (vi) Assets and records are required to be protected from unauthorized access, use or disposition.
- (vii) Records of assets such as sufficient description of the assets (to facilitate identification) its location should also be maintained so that the assets could be physically verified periodically.

For prompt, accurate, complete and appropriate recording of accounting transaction, several procedures are often established by the management. The assurance that transactions have been properly recorded can also be obtained through a comparison of records with an independent source of information which provides an indication of the execution of the relevant transactions.

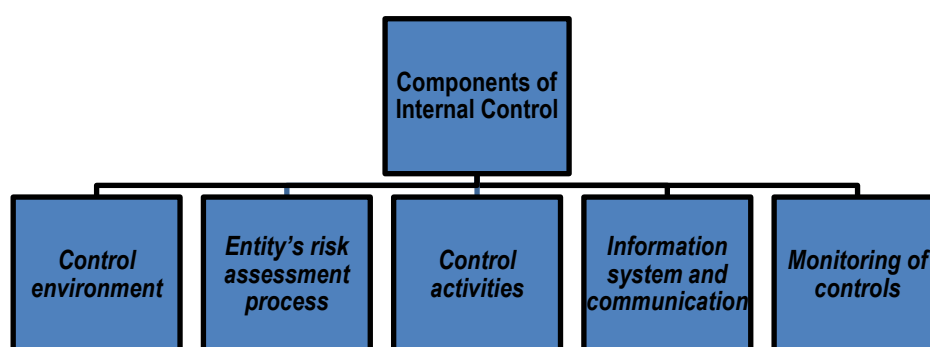
Accountability and Safeguarding of Assets - The process of accountability of assets commences from acquisitions of assets its use and final disposal. Safeguarding of assets requires appropriate maintenance of records, their periodic reconciliation with the related assets. Assets like cash, inventories, investment scrips require frequent physical verification with book records. The frequency of reconciliation would differ for different assets depending upon their nature and amount. Assets which are considered sensitive or susceptible to error need to be reconcile more frequently than others. For proper safeguarding of assets, only authorized personnel should be given access to such asset. This not only means physical access but also exercising control over processing of documents relating to authorization for use and disposal of assets. It is essential to have effective controls over physical custody of cash, inventories, investments and other fixed assets. In some cases, as per requirement, special procedures regarding physical custody of assets may have to be designed by the management.

Independent Checks - Independent verification of the control systems, designed and implemented by the management, involves periodic or regular review by independent persons to ascertain whether the control procedures are operating effectively or not. Such process may be carried out by specially assigned staff under the banner of external audit.

3.3 Components of Internal Controls

In general, a system of internal control to be considered adequate should include the following five components:

- (i) Control environment;
- (ii) Entity's Risk assessment Process;
- (iii) Control activities;
- (iv) Information system and communication;
- (v) Monitoring of Controls



I. Control environment: The control environment encompasses the following elements:

- (a) Communication and enforcement of integrity and ethical values. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.***
- (b) Commitment to competence. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.***
- (c) Participation by those charged with governance. An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with***

governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

- (d) Management's philosophy and operating style. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.*
 - (e) Organisational structure. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.*
 - (f) Assignment of authority and responsibility. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.*
 - (g) Human resource policies and practices. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.*
- (II) Entity's risk assessment process:** *For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.*

Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability

to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- (a) Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.*
- (b) New personnel. New personnel may have a different focus on or understanding of internal control.*
- (c) New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.*
- (d) Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.*
- (e) New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.*
- (f) New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.*
- (g) Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.*
- (h) Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.*
- (i) New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.*

(III) Control activities: *Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:*

- (a) Performance reviews. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.*
- (b) Information processing. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate*

to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- (c) *Physical controls. Controls that encompass:*
- *The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.*
 - *The authorisation for access to computer programs and data files.*
 - *The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.*
- (d) *Segregation of duties. Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.*

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

(IV) Information system, including the related business processes, relevant to financial reporting, and communication: *An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).*

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

- (a) *Identify and record all valid transactions.*

- (b) *Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.*
- (c) *Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.*
- (d) *Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.*
- (e) *Present properly the transactions and related disclosures in the financial statements.*

The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

(V) Monitoring of controls: *An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.*

Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider

3.12 Advanced Auditing and Professional Ethics

communications relating to internal control from external auditors in performing monitoring activities.

The overall systems of inter control comprises of Administrative Control and Accounting Controls, Internal Checks and Internal Audit are important constituents of Accounting Controls.

Internal Check System - Internal check system implies organization of the overall system of book-keeping and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof. It is a part of overall control system and operates basically as a built-in-device as far as organization and job-allocation aspects of the controls are concerned. The system provides existence of checks on the day to day transactions which operate continuously as part of the routine system whereby the work of each person is either proved independently or is made complimentary to the work of another. The following are the objectives of the internal check system:

- (i) To detect error and frauds with ease.
- (ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.
- (iii) To increase the efficiency of the staff working within the organization.
- (iv) To locate the responsibility area or the stages where actual fraud and error occurs.
- (v) To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
- (vi) To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

The effectiveness of an efficient system of internal check depends on the following considerations -

(i) Clarity of Responsibility - The responsibility of different persons engaged in various operations of business transactions should be properly identified. A well integrated organizational chart depicting the names of responsible persons associated with specific functions may help to fix up responsibility.

(ii) Division of Work - The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other. Then, it is suggested that rotation of different employees through various components of job should be effectively implemented.

(iii) Standardization - The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of the business, so as to strengthen the system of internal check.

(iv) Appraisal - Periodic review should be made of the chain of operations and work flow. Such process may be carried out by preparing an audit flow chart.

The general condition pertaining to the internal check system may be summarized as under -

- (i) no single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.
- (ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.
- (iii) Every member of the staff should be encouraged to go on leave at least once a year.
- (iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
- (v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
- (vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.
- (vii) Budgetary control should be exercised and wide deviations observed should be reconciled.
- (viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.
- (ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.
- (x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

The scope of statutory audit is limited by both time and cost. Therefore, it is increasingly being recognized that for an audit to be effective especially in case of large organization, the existence of a system of internal check is essential.

Internal Audit - Internal audit may be defined as, an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The scope of the internal audit is determined by the management. Internal auditing includes a series of processes and techniques through which an organizations own employees ascertain for the management, by means of on-the-job observation, whether established management controls are adequate, and are effectively maintained; records and reports financial, accounting and otherwise reflect actual operation and results accurately and properly; each division, department or other units are carrying out the plans, policies and procedures for which they are responsible.

Note: For a detailed discussion on internal audit refer to Chapter 19.

3.4 Review of the System of Internal Controls

The control environment sets the tone of an organization, influencing the control consciousness of its people. The control environment includes the governance and

3.14 Advanced Auditing and Professional Ethics

management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness or significant deficiency in the entity's internal control.

An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology.

Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- *Large, unusual or non-recurring transactions.*
- *Circumstances where errors are difficult to define, anticipate or predict.*
- *In changing circumstances that require a control response outside the scope of an existing automated control.*
- *In monitoring the effectiveness of automated controls.*

The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

The review of the internal control system enables the auditor -

- (i) to formulate his opinion as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and
- (ii) to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation. For example, if the auditor is not satisfied with the control system as regards trade receivable, he may decide to have a wider coverage for confirmation of trade receivables' balances. Normally, investments and cash are physically verified at the end of the period and this routine is known to the client and his employees. In case the auditor comes across a weakness in the control either he may provide in the programme for a surprise cash count or investment verification on a day preceding or succeeding the routine verification. In such a case, a surprise check will be more useful if it is undertaken after the routine verification is over.

Similarly, if he is of the view that because of weak controls the possibility of wrong billing to customers exists, he may extend the programme for comparison of the invoices with the forwarding notes and for checking of the extensions and castings of the invoices.

Deciding the point of time appropriate for undertaking the review of the internal controls is a matter for individual judgement of the auditor. This decision can be taken on a consideration of the size and complexity of the client's operations. If the auditor, because of his continuing relationship with his client, is already aware of the features and efficacy of internal controls, he may just review the changes that have taken place in the intervening period because of changes in the operations of the client. However, a comprehensive review in such cases must be made at an interval of, say, 3 years. Ordinarily, the review of internal controls should be undertaken as a distinct phase of audit before finalisation of the audit programme. However, if the size of operations is rather small, the review can be undertaken in conjunction with other audit procedures and the programmes can be adjusted for any extension or elimination of checking.

When the auditor finds inadequacies or weaknesses in the internal control system, he should advise his client about such inadequacies and weaknesses and the consequences that may follow. It should be the duty of the auditor to see, in the course of his audit, how far the inadequacies and weaknesses have been removed. He will take this into account in preparing his audit report. It is a useful practice to note the following after each function, set out in the audit programme -

- (a) Any change in the system of internal control from that record in the appropriate section of the internal control questionnaire.
- (b) Any further weakness noted in the internal control.
- (c) Any instance where the prescribed system or procedure has not been followed.

These should be considered in deciding whether any further modification in the audit programme is called for. Also, these should be communicated to the client and confirmation should be sought as regards changes in the system.

The review of internal control consists mainly of enquiries of personnel at various organisational levels within the enterprise together with reference to documentation such as procedures, manuals, job description and flow-charts, to gain knowledge about the controls which the auditor has identified as significant to his audit. The auditor may trace a few transactions through the accounting system to assist in understanding that system and its relation to internal controls. The auditor's preliminary evaluation of internal controls should be made on the assumption that the controls operate generally as described and that they function effectively throughout the period of intended reliance. The purpose of the preliminary evaluation is to identify the particular controls on which the auditor still intends to rely and to test through compliance procedures. Different techniques are used to record information relating to an internal control system. Selection of a particular technique is a matter for the auditor's judgement.

3.5 Methods of Recording

The following are the methods of recording:

3.5.1 Questionnaire: Because of the widespread experience that auditors possess about the

3.16 Advanced Auditing and Professional Ethics

business operations in general and the knowledge about the appropriate control, most of the auditing firms have developed their own standardised internal control questionnaire on a generally applicable basis. In developing the standard questionnaire, endeavour is made to make it as wide as possible so that all situations, generally found, are included therein but all of these may not be applicable in a particular case. A questionnaire is a set of questions framed in an organised manner, about each functional area, which has as purpose the evaluation of the effectiveness of control and detection of its weakness if any. A questionnaire usually consists of several separate sections devoted to areas such as purchases, sales, trade receivables, trade payables, wages, etc. The questionnaire is intended to be filled by the company executives who are in charge of the various areas. However, this poses some practical difficulties. The questionnaire is to travel from executives and, therefore, it may take a pretty long time to be filled; also the questions may not be readily intelligible to busy executives and there is a possibility of the questionnaire being misplaced while travelling from one table to another. Having regard to these difficulties, it is now almost an accepted practice that the auditor (or his representative) arranges meetings with the executives concerned and gets the answers filled by each executive. Sometimes, the auditor himself may be required to fill the answers. In such a case, he should ensure that the concerned executive has initiated the answers as a token of his agreement therewith.

Questions are so framed as generally to dispense with the requirement of a detailed answer to each question. For this purpose, often one general question is broken down into a number of questions and sub-questions to enable the executive to provide a just 'Yes', 'No' or 'Not applicable' form of reply. Questions are also framed in such a manner that generally a "No" answer will effect weakness in the control system. This requires giving a positive power to the question, keeping in view what the proper control should be. Consider the question 'Are all receipts recorded promptly and deposited in bank daily? If the answer to this is 'Yes', it fits with the plan of good internal control. But if it is 'No' it indicates weakness in the system in as much as the moneys received may not be recorded and may be defalcated because the cashier has continued control over the amount for an uncertain period. However, this should not be taken as an unbreakable rule. Questions may be framed also when a 'Yes' answer would indicate weakness. The only thing that should be borne in mind is that the scheme of questions should be consistent, sequential, logical, and if possible corroborative. Wherever it is necessary, slightly detailed answers also may be asked for to bring clarity to the matter. In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -

- (i) Certain procedures in general used by most business concerns are essential in achieving reliable internal control. This is a time-tested assumption. Deposit into bank of the entire receipts of a day or daily balancing of the cash book and ledgers or periodic reconciliation with the control accounts are examples of widely used practices which are considered good internal control practices. Besides, basic operations giving rise to these practices exist in all businesses irrespective of their nature.
- (ii) Organisations are such that permit an extensive division of duties and responsibilities. The larger the organisation, the greater is the scope of such division.

- (iii) Employees concerned with accounting function are not assigned any custodial function.
- (iv) No single person is thrust with the responsibility of completing a transaction all by himself.
- (v) There should always be evidence to identify the person who has done the work whether involving authorisation, implementation or checking.
- (vi) The work performed by each one is expected to come under review of another in the usual course of routine.
- (vii) There is proper documentation and recording of the transactions.

The questionnaire serves the purpose of a record so far as the auditor is concerned about the state of internal control as given to him officially. A question naturally arises as to whether it is necessary to issue questionnaire for every year of the auditor's engagement. For the first year of engagements issue of questionnaire is necessary. For subsequent years, the auditor, instead of issuing a questionnaire again, may request the client to confirm whether any change in the nature and scope of business has taken place that necessitated a corresponding change in the control system, or whether, even without a change in the nature and scope of business, the control system has undergone a change. If there has been a change, the auditor should take note of its and enter appropriate comments on the relevant part of the questionnaire. However, it would be a good practice in the case of continuing engagements to issue a questionnaire irrespective of any change, say, every third year. This will obviate unnecessary trouble of filling the answers every time and to that extent the client's and the auditor's own time will be saved. The rationale for issuance of a questionnaire every three years, in the case of even no change, lies in altering the client as regards unnoticed and unspectacular changes that might have taken place during the intervening period; also this will make the client more control-conscious. Questionnaires can be prepared for various aspects of the internal control system.

3.5.2 Check List: It is a series of instructions or questions on internal control which the auditor must follow or answer. When a particular instruction is carried out, the auditor initials the space opposite the instruction. If it is in the form of a question, the answer generally 'Yes', 'No' or 'Not Applicable' is entered opposite the question. A check list is more in the nature of a reminder to the auditor about the matters to be checked for testing the internal control system. While a questionnaire is basically a set of questions put to the client, a check list which may be in a form of instructions, questions or just points to be checked may be meant for the auditor's own staff it is a set of instructions or points; it may be meant for the client if it is in the form of questions. The question form of check list may even be meant for the auditor's own staff. For example, questions in the check list may be formed in the following manner (this is an illustrative set of questions to be answered by the audit staff).

Have you checked that the cashier-

- (i) is not responsible for opening the incoming mails;
- (ii) does not authorise any of the ledgers;
- (iii) does not authorise any expenditure or receipt;

3.18 Advanced Auditing and Professional Ethics

- (iv) does not sign cheques;
- (v) takes his annual leave regularly;
- (vi) inks and balances the cash book everyday;
- (vii) verifies physical cash balance with the book figure daily at the end of the day;
- (viii) prepares monthly bank reconciliation statement;
- (ix) holds no other funds or investment;
- (x) holds no unnecessary balance in hand;
- (xi) does not pay money without looking into compliance with proper procedure and due authorisation; and
- (xii) has tendered proper security or has executed a fidelity bond?

When the check list is in question form, it is hardly different from a questionnaire. However, generally questionnaire is a popular medium for the evaluation of the internal control system.

The basic distinction between internal control questionnaire and check list are as under:

1. The ICQ incorporates a large number of detailed questions but the check list generally contains questions relating to the main control objective with the area under review.
2. ICQ, the weaknesses are highlighted by the 'Yes' while in the check list, it is indicated by 'No'.
3. The significance of 'No' in an ICQ does indicate a weakness but the significance of that weakness is not revealed automatically. However, in the check list, a specific statement is required where an apparent weakness may prove to be material in relation to the accounts as a whole.

3.5.3 Flow chart: The flow charting technique can also be resorted to for evaluation of the internal control system. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section. As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart, narratives, though cannot perhaps be totally banished are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. It gives a bird's eye view of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart. Essentially a flow chart is a diagram full with lines and symbols and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organisation. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or

department involving flow of documents and activities. More specifically it can show -

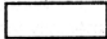



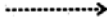




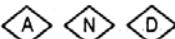








- (i) at what point a document is raised internally or received from external sources;
- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, department or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal by sending out or destruction.

As a matter of fact a very sound knowledge of internal control requirements is imperative for, adopting flow-charting technique for evaluation of internal controls; also it demands a highly analytical mind to be able to see clearly the inter division of a job and the appropriate control at relevant points.

It has been stated earlier that flow charts should be made section-wise or department-wise. The suggestion has been made to ensure readability and intelligibility of the flow charts.

Drawing of a flow chart - A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column heads; in appropriate cases an individual also may be shown as the vertical column head. Care should be taken to see that the first column head is devoted to the section or the individual wherefrom a transaction originates and the placements of other column heads should be in the order of the actual flow of the transaction. It has been stated earlier that a flow chart is a symbolic representation the flow of activity and related documents through the section from origin to conclusion. These can be sales, purchases, wages, production, etc. Each one of the main functions is to be linked with related functions for making a complete course. Purchase is to be linked with trade payables and payments; sales with trade receivables and collections. By this process, a flow chart will become self contained, complete and meaningful for evaluation of internal controls.

3.20 Advanced Auditing and Professional Ethics

SYMBOLS	
	Documents
	Documents prepared
	If copy made
	Flow of documents
	Used for next step
	Fork (alternative possibilities)
	Dead-end (leaves charted system)
	Permanent file of documents (alphabetically, numerically, or by date)
	Serial continuity checked, unimportant, or unchecked respectively
	Temporary file of documents (alphabetically, numerically, or by date)
	Attached
	Destroyed
	Initials
	Signs
	Book or Ledger
	Posting source
	Keyed to explanatory note
	Starting points.

Generally, a questionnaire is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart. This is an evaluation of the control system through the process of flow charting. The internal control questionnaire contains questions; answers are available in the flow chart and they will reveal weakness, if any, in the system. In fact, the questionnaire is a guide for the study of a control system through flow charts.

We may examine the flow charting techniques for evaluation of internal controls on the sales and trade receivables function. Let us assume that these are -

1. Order receiving function.
2. Dispatch function.
3. Billing function.
4. Accounting in the trade receivables' ledger.
5. Main accounting functions.
6. Inventory recording function.

All these functions are carried out in distinct sections. As regards the Order Receiving Section, let us further assume that the section receives orders:

- (i) through mail;
- (ii) by telephone; and
- (iii) through the company's salesmen.

Basing the receipts of orders of customers, the section raises internal "Sales advices". These sales advices are consecutively numbered (by reference to the last number on the order book) and entered in the order book with the consecutive number, date, the party and other relevant details. The orders received from customers are temporarily filed in the alphabetical order. The sales advices are prepared in sets of four with a noting for the customer's sales-tax status. All the four copies are sent to the dispatch section. The dispatch section, after dispatch of the goods, sends back to the Order receiving Section the last copy of the sales advice after entering thereon the date of dispatch and the quantity despatched. Upon receipt of the last copy, the Order receiving Section enters the date of dispatch and the quantity despatched in the order book. If the quantity despatched is fulfillment of the quantity ordered, the last copy of the sales invoices is annexed to customer's order and filed in the customer's file. If, however, the order is only partly executed, the copy of the sales advice is kept in a temporary file in numerical order. Periodically this file is checked to determine the unfulfilled orders and, if inventory is then available, the Section again initiates fresh sales advices in respect of the unfulfilled part and all the processes, as in the case of original, are repeated. The last copy of the original set is annexed to the customer's order and kept in the customer's file.

The salesmen use the same advice form as is being used by the order receiving section.

For the purpose of drawing a flow chart to incorporate the above narration it is useful to know -

1. the point for originating the flow of transaction.
2. the documents, internal and external, and the flow of the transaction, number of copies, distribution flow and the details.
3. the books, if any, maintained and the details recorded there in and the source or sources for the details.
4. that there exists an alternative possibility.

The flow chart for the above may be as under -

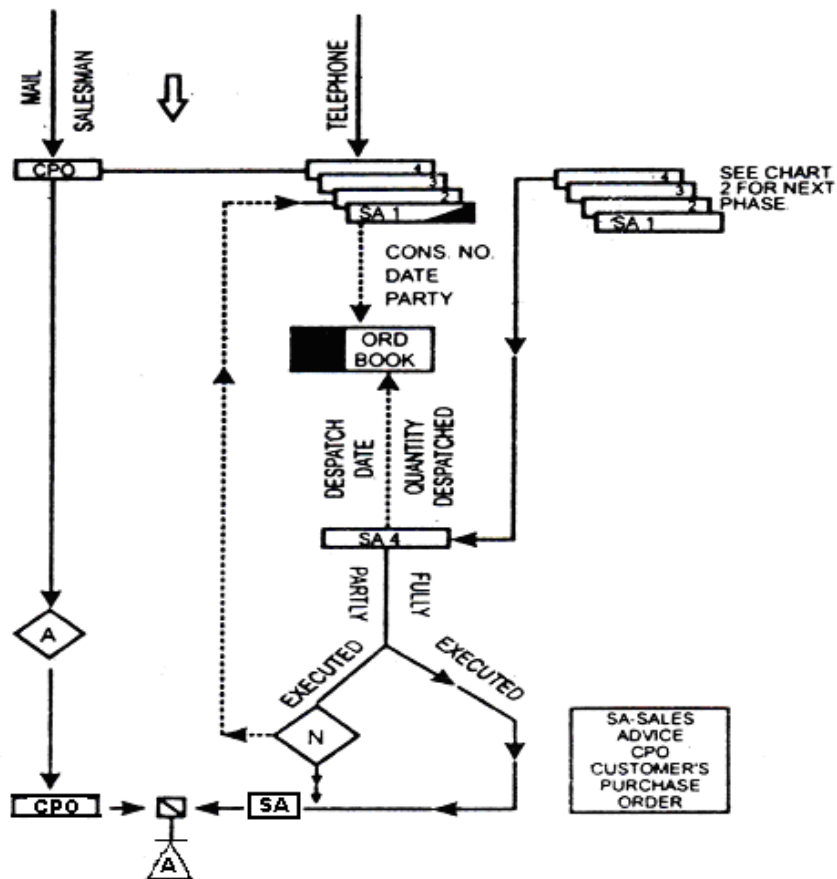


CHART 1

We can extend the activity flow now to the dispatch section which is the logical second stage of operation. The work and procedure content of the dispatch section is assumed to be as follows:

After the receipt of the sales advices in sets of four, the dispatch section arranges dispatch of materials and put the date of dispatch and the quantities despatched; the head of the Section initials the advices. The last copy of the advice is sent back to the Order Receiving Section. The first copy is sent as a packing slip with the goods, the second copy goes to the Billing Department and the third copy accompanies the goods when delivered to the buyer and, obtaining the buyer's acknowledgement of the receipt of the goods therein, is received back and filed date-wise. In case of goods not directly delivered to the buyers, i.e., when the goods are sent either by rail, road or water transport, the copy constitutes the basis for raising the relevant forwarding note on the basis of which R.R. etc., can be prepared.

The flow chart for the dispatch section may be as follows -

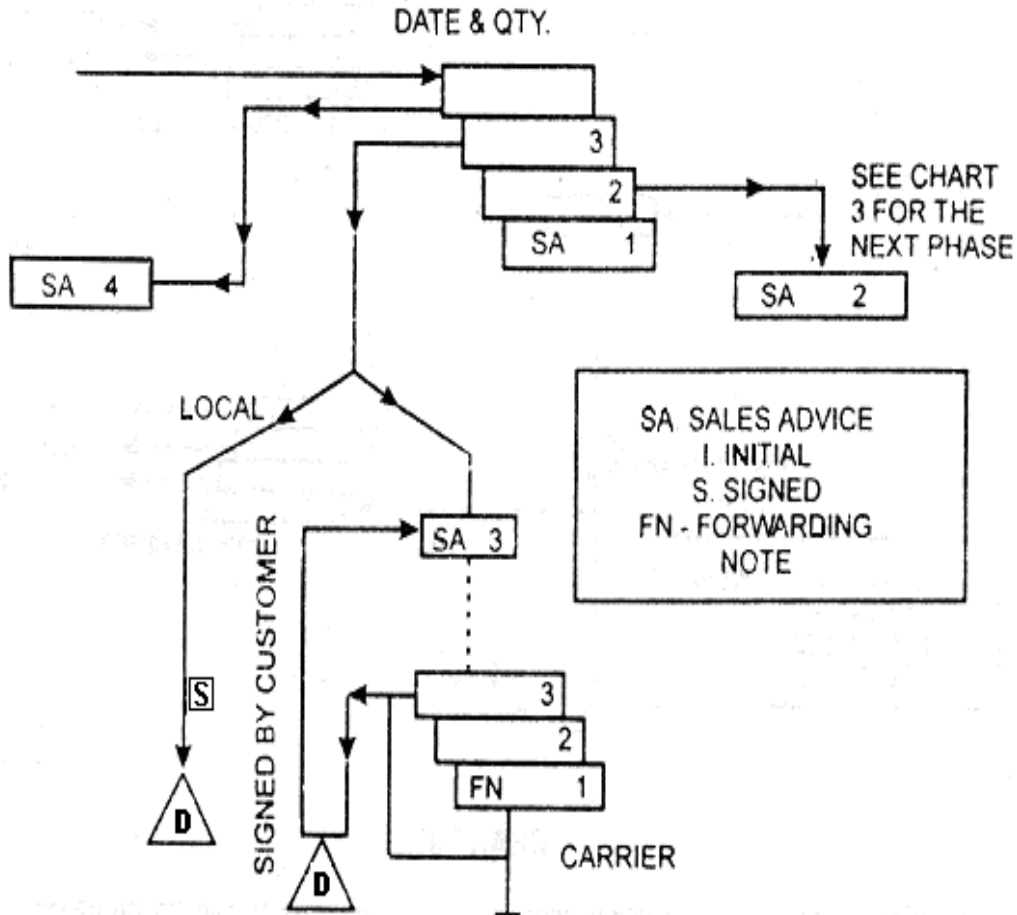


CHART 2

This flow is taken to the Billing Section. The Section generally accumulates the second copy of the Sales Advice for two or three days and prepares sales invoices in sets of four. The pricing of the sales invoice is done by reference to the company's current price list or the catalogue. The number of the sales advice is entered on the corresponding invoice which is pre-numbered, also, the number of the invoice is recorded on the copy of the sales advice which is then filed alphabetically. The first copy of the invoice is sent to the customer while the second, third and fourth copies are respectively sent to the trade receivables ledger clerk, the Inventory Section and the Accounts Section. The Billing Section also is responsible for raising credit notes on the basis of documents received. Credit notes are also prepared in sets of four and are distributed in exactly the same way as invoices. The inventories of invoice and the credit note forms remain in the Billing Section.

3.24 Advanced Auditing and Professional Ethics

The Flow Chart for this Section is given below -

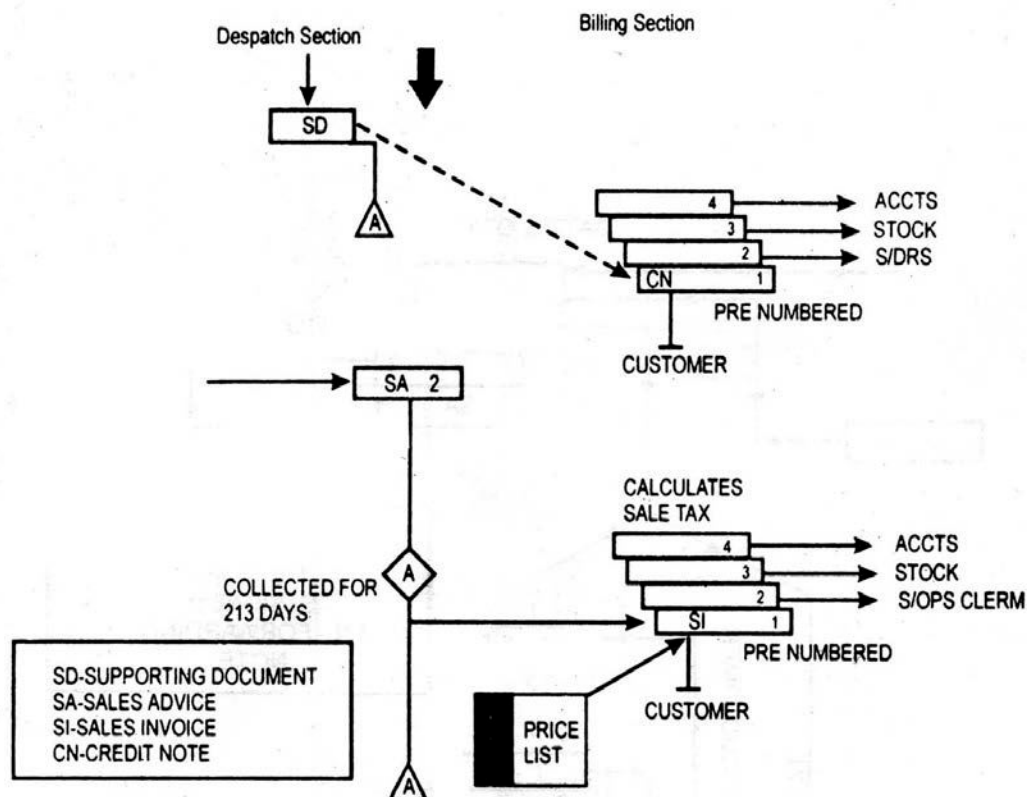


CHART 3

Now, in the order of the flow of activities, more sectional flow charts can be prepared to cover the activities in the Accounts Section and the Inventory Section and they together, when sequentially assembled, will constitute the complete flow chart for the sales transactions and trade receivables recordings.

(These flow charts have been prepared on the basis of the approach and the symbols used in the book "Analytical Auditing" by Skinner and Anderson. Students who desire to study the subject of preparation of flow charts further may refer to Chapter 4 of that book.)

It is now left for us to see how these flow charts reveal the state of internal control. A close look into flow charts will show the following:

- (i) The advices are sent by salesmen; though prepared on the same sales advice form as is prepared in the section, there is no check that all the advices sent by salesmen have been received. This may entail loss of business because of non-receipt of sales advice. (Refer

to the flow chart for the Order Receiving Section).

- (ii) The raising of sales advices on the basis of telephonic orders, irrespective of the party's standing and record of performance is risky from the business point of view. (Refer to the flow chart for the Order Receiving Section).
- (iii) There is no system of prior credit sanction to the parties; in consequence, there may be dispatch of goods to bad credit risks. (Refer to the flow chart for the Dispatch Section).
- (iv) There is no check that all the second copies of the sales advices sent by the Dispatch Section have been received by the Billing Section. The possibility of dispatch not being billed exists, (Refer to the flow chart for the Dispatch as well as the Billing Section).
- (v) There is no check in respect of pricing, extension and addition on the invoice or the credit notes. This may result in loss of revenue for wrong pricing or wrong calculation. (Refer to the flow chart for Billing Section).
- (vi) It is not clear whether the supporting documents are adequate for authorising the issue of credit notes where there is a need for a greater caution. (Refer to the flow chart for Billing Section).

So far we have seen the points of weaknesses that are evident from these flow charts. For a clearer understanding of the flow chart as a medium for evaluating internal controls, the following further points may be useful:

- (a) There exists proper numerical control over orders booked (except the case for the salesmen's orders).
- (b) There is a permanent and continuous record of the orders booked in the form of order book.
- (c) There is a definite basis for raising sales advices.
- (d) The order book record is always kept complete by entering the information about the execution of the order and this keeps the information about the pending orders ready at any moment.
- (e) Partly executed orders are reviewed from time to time so that as soon as goods are available, the same may be despatched to customers.
- (f) The customer's purchase order and the related sales advice are matched and kept together in the customer's file.
- (g) The sales advices are initialed by the Dispatch Section head as token of his having satisfied himself about the correctness of the entries as regards the quantity despatched and the date of dispatch.
- (h) Record of actual direct delivery is maintained through the copy of the sales advice bearing the customer's, acknowledgement of his having received the goods. Similarly, the record of out station deliveries is kept in the copy of the forwarding note annexed to the sales advice copy.

3.26 Advanced Auditing and Professional Ethics

- (i) Documents have as many copies as are necessary for ensuring proper flow and proper control. There is neither wastage through unnecessary copies nor any hold up because of inadequacy of copies.
- (j) There are supporting documents for raising invoices and credit notes.
- (k) The distribution of invoices and credit notes is such as would enable the recording of billing at the relevant centres independent of each other.
- (l) There is control over the number of invoices and credit notes by pre-numbering.

Thus, by flow charting has an auditor can very clearly see the inter-relationships of the activities and flows and how they are integrated from stage to stage. However, the auditor has to be careful about the readability and intelligibility of the chart. Identification of all individual functions in a section is also highly relevant for preparation of the flow chart. The smaller the segment, the better is the possibility of quick comprehension. Naturally, the auditor should try to see each section as the natural assembly of distinct and identified components.

3.6 Internal Control and Risk Assessment

The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity. Such an understanding would also help the auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan. In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled regularly. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

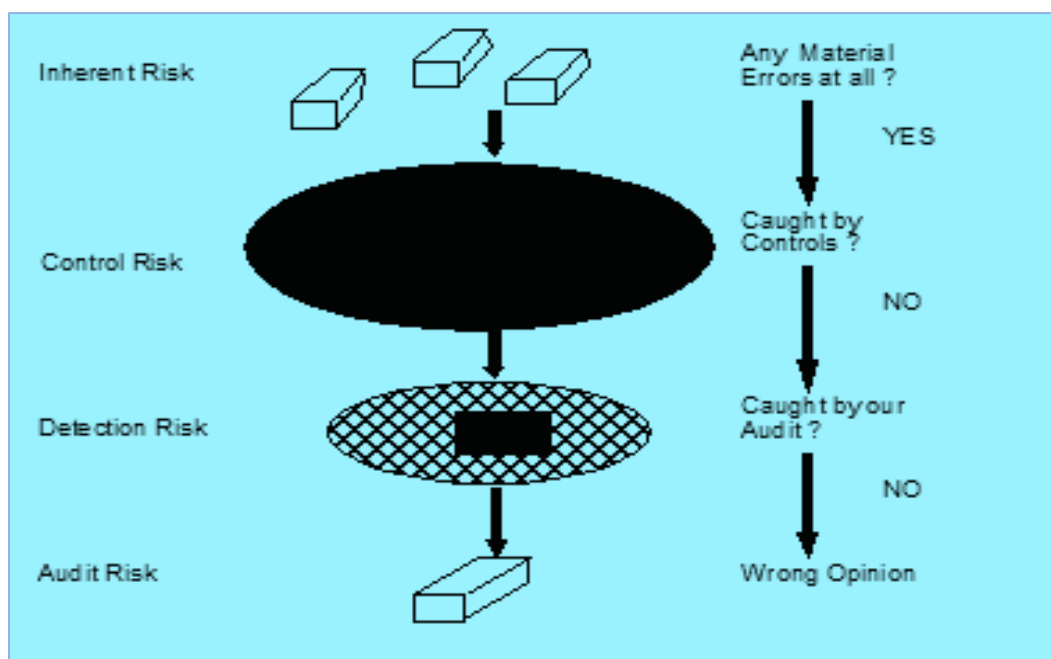


Fig.: Risks of Material Mis-statement*

An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheet items. Audit risk is a function of the risks of material misstatement and detection risk.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements. The nature of each of these types of risk and their interrelationship is discussed below:

- (i) **Inherent risk:** It is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

* Source : Source : cjess1 audit class pln - WordPress.com

3.28 Advanced Auditing and Professional Ethics

- (ii) **Control Risk:** It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements.

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

- (iii) **Detection Risk:** It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

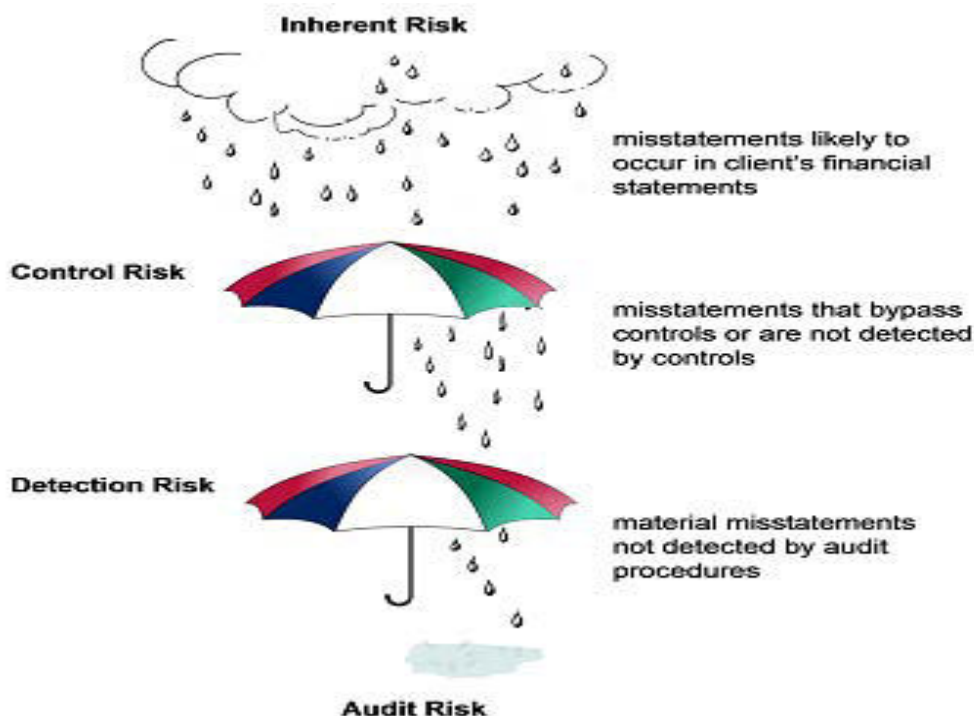


Fig.: Audit Risk*

* Source: cplusglobal.com - WordPress.com

The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

3.6.1 Control Risk: Preliminary Assessment of Control Risk - After obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.

The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. The preliminary assessment of control risk is based on the assumption that the controls operate generally as described and that they operate effectively throughout the period of intended reliance. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

The auditor ordinarily assesses control risk at a high level for some or all assertions when:

- (a) the entity's accounting and internal control systems are not effective; or
- (b) evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

In the above circumstances, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements.

The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:

- (a) is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and
- (b) plans to perform tests of control to support the assessment.

Documentation of Understanding and Assessment of Control Risk - The auditor should document in the audit working papers:

- (a) the understanding obtained of the entity's accounting and internal control systems; and
- (b) the assessment of control risk.

When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.

Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgement. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control

3.30 Advanced Auditing and Professional Ethics

systems. Generally, the more complex the entity's accounting and internal control systems and the more extensive the auditor's procedures, the more extensive the auditor's documentation will need to be.

Tests of Control - Tests of control are performed to obtain audit evidence about the effectiveness of the:

- (a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
- (b) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

Tests of control may include:

- ◆ Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- ◆ Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- ◆ Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- ◆ Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.

When obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period

and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance. The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the less assurance that may result.

The auditor should consider whether the internal controls were in use throughout the period. If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be

3.32 Advanced Auditing and Professional Ethics

applied to the transactions and other events of that period.

The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period. Factors to be considered include:

- ◆ The results of the interim tests.
- ◆ The length of the remaining period.
- ◆ Whether any changes have occurred in the accounting and internal control systems during the remaining period.
- ◆ The nature and amount of the transactions and other events and the balances involved.
- ◆ The control environment, especially supervisory controls.
- ◆ The nature, timing and extent of substantive procedures which the auditor plans to carry out.

Final Assessment of Control Risk

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

3.6.2 Relationship between the Assessments of Inherent and Control Risk: Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

3.6.3 Detection Risk: The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor was to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. In this regard the auditor would consider:

- (a) the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;
- (b) the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and
- (c) the extent of substantive procedures, for example, using a larger sample size.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk.

The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.

The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

Mathematically Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. $AR = IR \times CR \times DR$

It should be noted that:

1. the combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and
2. Audit Materiality is also inversely related with audit risk.

3.34 Advanced Auditing and Professional Ethics

The relationship between different components of audit risks is given in the following table:

		Auditors' assessment of control risk		
		High	Medium	Low
Auditors' assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The shaded areas in this table relate to detection risk.

3.7 Internal Control in Small Business Enterprises

The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However many controls which would be relevant to large entities are not practical in small business. For example, in a small business, accounting procedures may be performed by a few persons. These persons may have both operating and custodial responsibilities and segregation of functions may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by supervisory controls exercised by the owner. This supervisory function by the owner becomes possible because of the fact that he has direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited and the evidence of supervisory controls is lacking the evidence necessary to support the auditor's opinion on the financial information may have to be obtained largely through substantive procedures.

3.8 Reporting to Clients on Internal Control Weaknesses

During the course of audit work, the audit may notice material weaknesses in the internal control system. Material weaknesses are defined as absence of adequate controls on flow of transactions that increases the possibility of errors and frauds in the financial statements of the entity. For example, if monthly age-wise analysis of trade receivables is not performed then it may result in inadequate provisioning of bad debts for the fiscal year under audit.

The auditor should communicate such material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows:

- (a) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.
- (b) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been

designed to determine the adequacy of internal control for management.

- (c) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
- (d) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

It should be appreciated that by writing a letter to the management about the weaknesses in the system, the auditor is not absolved from his duty to report the shortcomings in the accounts by way of qualification where the defects have not been corrected to the auditor's satisfaction weighing the materiality of weaknesses and their impact, if considered necessary.

The practice of the issue of letter of weaknesses has a great merit in relieving the auditor from liability in case serious frauds or losses have occurred, which probably would not have taken place had the client taken due note of the auditor's points in the letter of weakness. In the case *Re S.P. Catterson & Ltd.* (1937, 81, Act L.R. 62), the auditor was acquitted of the charge of negligence for employee's fraud in view of the fact that he had already informed the client about the unsatisfactory state in the specific areas of accounts and had suggested improvements which were not acted upon by the management.

The Council of ICAI has issued SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" in this regard. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330.

SA 260 "Communication with those charged with Governance" establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

CASE STUDY

Accounting Systems and Internal Controls[∞]

EdukIT International Ltd. runs four private colleges which provide education and training for people in the information technology industry. Its two-year course includes training in data processing, multimedia, animation, etc. M/s. Tick Tack & Co. are conducting the interim audit for the year ended 30th June 2005. The tangible fixed assets of each college are recorded in an asset register which is maintained at each college location by the respective college manager. The system operates as described below:

- In order to obtain new assets, a purchase requisition form is completed and approved by the manager at each college.
- The requisition is sent to the head office, where the purchases officer checks the requisition for approval and completes the purchase order for the new asset.
- Assets costing more than ₹ 50,000, are approved by the head of the Accounts Department. All assets over ₹ 2,00,000 require Board of Directors' approval.
- The purchase order is then sent to the supplier and a copy is sent to the central store at the location of the head office.
- The asset is received by the central store where the receiving clerk checks that all the asset details agree with those on the goods received note and the copy of the purchase order. The receiving clerk then issues the asset with its computer-generated sequential barcode number. This barcode is fixed to the asset and written on the goods received note and the supplier invoice.
- The relevant college manager inputs the new asset details into the asset register using a copy of the purchase order, the original requisition and the asset's barcode.
- For disposal or write-off of an asset, an asset disposal write-off form is completed by the relevant college manager, signed and sent to the head office. Disposals and write-offs are approved by the head of the Accounts Department. A copy of the form is filed at the head office and the approved original returned to the college manager for action. The college manager then updates the fixed asset register for the subsequent disposals/write-off.
- The asset register is maintained on tailored fixed assets accounting software systems, known as FAST and reconciled to the general ledger by each college manager monthly.
- The FAST system calculates depreciation automatically each month using the rate input by the college manager at the time the asset was added to the register.

Queries to the Readers

- i) Identify five internal control strengths in the above case on which the auditor can place reliance.
- ii) What tests of control should be designed to evaluate the effectiveness of each of the controls identified.

[∞] Adapted from the case study published in Modern Auditing, Graham W Cosserat, (second edition), John Wiley & Sons, pg. 252.

ANNEXURE

The Sarbanes-Oxley Act of 2002

The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom.

Sarbanes Oxley Act, 2002

The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. The act contains eleven titles, the summary of which is given hereunder:

Title I - Public Company Accounting Oversight Board (PCAOB) Established is an independent private board, to regulate the accounting profession, to be dominated by executives and experts from outside the accounting profession (a self-regulatory body so far). This setup aims at establishing Public confidence in the 'Report of independent Registered Public Accounting Firm' and to protect the interest of investors. The PCAOB requires the Public Accounting Firms to register with the Board and to follow certain regulations for audit of Public Companies.

Title II – Auditor Independence

The auditors of Public Companies to follow:

- ◆ Regulatory authorities –Securities Exchange Board (SEC) as SEC was entrusted to issue rules implementing several of the provisions of Sarbanes Oxley Act.
- ◆ To comply with the PCAOB rules and regulations.
- ◆ To enhance the rights, duties and responsibilities of the Audit Committee.

Title III – Corporate Responsibility

- ◆ The Audit Committee to be more independent through enhancement of their Oversight responsibilities and one of the Audit Committee member to be “Financial Expert”.
- ◆ Requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to issue certification of quarterly financial results and annual reports to SEC as part of compliance with form 10-K quarterly Report under Section 13 or 15(d) of the Security and Exchange Act of 1934 or Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
- ◆ Provides rules of conduct for companies management and their officers regarding pension matters.
- ◆ To comply with the Securities and Exchange Board rules requiring attorneys to report violations of securities laws to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.

3.38 Advanced Auditing and Professional Ethics

Title IV – Enhanced Financial Disclosures

- ◆ Obligatory for the companies to provide objective and transparency in disclosure of financial results having established effectiveness of internal control systems for financial reporting and disclosures covering off balance sheet transactions.
- ◆ Disclosure the corporate mission statement and corporate ethics and their implementation.
- ◆ Disclosure by CEO, directors, management of the company and principal stockholders involving company securities.

Title V- Analyst Conflicts of Interest

- ◆ Declaration by Securities Exchange Committee (SEC) of rules to address conflicts of interest arising when securities analysts recommend equity securities buying and selling in their Research Report and announcement to public.

Title VI – Commission Resources and Authority

- ◆ To provide additional funding to SEC.
- ◆ Power to SEC and federal courts to censure and impose prohibitions on persons and corporate entities.

Title VII – Studies and Reports

- ◆ Federal regulatory bodies to conduct studies regarding Accounting firms, Credit Rating Agencies, violation of laws, rules and regulations by various agencies concerning corporate affairs and action involving securities laws.

Title VIII – Corporate and Criminal Fraud Accountability

- ◆ To enforce tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice.
- ◆ In case of violation of securities laws there may be debts non-dischargeable.
- ◆ Protect employer against corporate whistle blowers (person who provide evidence of fraud in the company).

Title IX – White- Collar Crime Penalty Enhancements

- ◆ Tougher practices for CEO's guilty of wrong doing and other fraud such as mail and wire fraud and ERISA violations.
- ◆ Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to issue certification in their quarterly, Half-yearly and Annual Reports to SEC forming part of Form 10 K and 10 Q under Section 13 or 15(d) of the Securities Exchange Act of 1934 and impose penalties for certifying a misleading or fraudulent report.

Title X – Corporate Tax Returns

- ◆ CEO should sign company's federal tax returns.

Title XI – Corporate Fraud and Accountability

Provide regulatory bodies and courts to take various actions –civil and criminal proceedings in connection of misstatements amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retaliating against corporate whistleblowers.

Overview of PCAOB'S Requirements for Auditor Attestation of Control Disclosures

Auditing Standards of the Public Company Accounting Oversight Board (PCAOB) has the following key requirements:

- ◆ The design of controls-relevant assertions related to all significant accounts and disclosures in the financial statements;
- ◆ Information about how significant transactions are initiated, authorized, supported, processed, and reported;
- ◆ Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur;
- ◆ Controls designed to prevent or detect fraud, including who performs the controls and the regulated segregation of duties;
- ◆ Controls over the period-end financial reporting process;
- ◆ Controls over safeguarding of assets;
- ◆ The results of management's testing and evaluation.

Internal controls - Under Sarbanes-Oxley, two separate certification sections came into effect – one civil and the other criminal. Section 302 of the Act mandates a set of internal procedures designed to ensure accurate financial disclosure. The signing officers must certify that they are “responsible for establishing and maintaining internal controls” and “have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared.” The officers must “have evaluated the effectiveness of the company’s internal controls as of a date within 90 days prior to the report” and “have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.”

Moreover, under Section 404 of the Act, management is required to produce an “internal control report” as part of each annual Exchange Act report. The report must affirm “the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.” The report must also “contain an assessment, as of the end of the most recent fiscal year of the Company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.” Id. To do this, managers are generally adopting an internal control framework such as that described in COSO.

Information Technology and SOX 404

The PCAOB suggests considering the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework in management/auditor assessment of controls. Auditors have also looked to the IT Governance Institute's "COBIT: Control Objectives of Information and Related

3.40 Advanced Auditing and Professional Ethics

Technology" for more appropriate standards of measure. This framework focuses on information technology (IT) processes while keeping in mind the big picture of COSO's "control activities" and "information and communication". However, these certain aspects of COBIT are outside the boundaries of Sarbanes-Oxley regulation. Refer to the Study Material of Information System Control and Audit for a detailed discussion on COBIT.

The financial reporting processes of most organizations are driven by IT systems. Few companies manage their data manually and most companies rely on electronic management of data, documents, and key operational processes. Therefore, it is apparent that IT plays a vital role in internal control. As PCAOB's states:

"The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting."

Chief information officers are responsible for the security, accuracy and the reliability of the systems that manage and report the financial data. Systems such as ERP (Enterprise Resource Planning) are deeply integrated in the initiating, authorizing, processing, and reporting of financial data. As such, they are inextricably linked to the overall financial reporting process and need to be assessed, along with other important process for compliance with Sarbanes-Oxley Act. So, although the Act signals a fundamental change in business operations and financial reporting, and places responsibility in corporate financial reporting on the chief executive officer (CEO) and chief financial officer (CFO), the chief information officer (CIO) plays a significant role in the signoff of financial statements.

The SEC identifies the COSO framework by name as a methodology for achieving compliance. The COSO framework defines five areas, which when implemented, can help support the requirements as set forth in the Sarbanes-Oxley legislation. These five areas and their impacts for the IT Department are as follows:

Risk Assessment - *Before the necessary controls are implemented, IT management must assess and understand the areas of risk affecting the completeness and validity of the financial reports. They must examine how the company's systems are being used and the current level and accuracy of existing documentation. The areas of risk drive the definition of the other four components of the COSO framework.*

Control Environment - *An environment in which the employees take ownership for the success of their projects will encourage them to escalate issues and concerns, and feel that their time and efforts contribute to the success of the organization. This is the foundation on which the IT organization will thrive. Employees should cross train with design, implementation, quality assurance and deployment teams to better understand the entire technology lifecycle.*

Control Activities - *Design, implementation and quality assurance testing teams should be independent. ERP and CRM systems that collect data, but feed into manual spreadsheets are prone to human error. The organization will need to document usage rules and create an audit trail for each system that contributes financial information. Further, written policies should define the specifications, business requirements and other documentation expected for each project.*

Monitoring - *Auditing processes and schedules should be developed to address the high risk areas within the IT organization. IT personnel should perform frequent internal audits. In addition, personnel from outside the IT organization should perform audits on a schedule that is appropriate to the level of*

risk. Management should clearly understand and be held responsible for the outcome of these audits.

Information and Communication - Without timely, accurate information, it will be difficult for IT management to proactively identify and address areas of risk. They will be unable to react to issues as they occur. IT management must demonstrate to company management an understanding of what needs to be done to comply with Sarbanes-Oxley.

U.S. and non-U.S. public companies have been subject to the disclosure controls and procedures and the internal accounting controls certification requirements of Section 302 of the Act since August 29, 2002, when the SEC published its final rules regarding Certification of Disclosure in Companies' Quarterly and Annual Reports (the "August 29th Final Rules"). U.S and non-U.S. Public Companies have also been subject to the certification requirements of Section 906 of the Act since July 30, 2002.

Difference between Disclosure Controls and Procedures and Internal Control over Financial Reporting

Because both the August 29th Final Rules and the June 5th Final Rules deal with "Disclosure Controls And Procedures" and "Internal Control Over Financial Reporting," it is important to understand the basic difference between them.

'Disclosure Controls and Procedures' are meant to ensure, as far as possible, that all the information required by law to be included in the periodic reports filed with the SEC is made available to those responsible for preparing them in a complete and timely fashion. 'Internal Control Over Financial Reporting' is meant to ensure the integrity of the financial statements and guard the assets of the company. At the bookkeeping level, these procedures are designed to enforce the proper recording of income and expenditure so that revenues are deposited into the company's bank account and unauthorized expenditures do not leave the company's bank account. At the executive level, these procedures are designed to prevent manipulation of revenues and expenses, such as illegal transfers from expense accounts to capital accounts, in which management may be tempted to engage in order to hit the end of the period "whispered numbers".

Because most periodic reports contain financial statements, there is some inevitable overlap between the two sets of controls. Considering the accounting lapse in the US, this overlap is considered as a good procedure. The Disclosure Controls and Procedures and the Internal Control Over Financial Reporting are sometimes collectively referred to in this advisory as "the Controls and Procedures."

Evaluation of Disclosure Controls and Procedures - The disclosure committee may plan to review and evaluate the check list at least quarterly in the case of U.S. companies and annually in the case of non-U.S. companies for the following:

- ◆ staffing inadequacies in the disclosure process;
- ◆ the level of experience of those drafting the reports;
- ◆ the reliability of the information systems used;
- ◆ whether those preparing the reports have access to the persons that have the information required and whether such persons are responsive to requests for information;
- ◆ whether sufficient time was allowed for review, comment and Q&A on drafts; whether transaction files were complete or were missing documents;

3.42 Advanced Auditing and Professional Ethics

- ◆ whether material transactions and issues were included in early drafts and how long did it take for issues to surface;
- ◆ whether disclosures were accurate; whether form checks revealed any problems and if so whether they were corrected;
- ◆ whether there are adequate controls over related party transactions; and
- ◆ Whether there was sufficient time to discuss issues and maintain a sufficient dialog between the gatekeepers of the information. The results of this periodic evaluation should be discussed with the CEO, CFO, the board of directors and the audit committee.

Other Functions of the Disclosure Committee - *Other functions of the disclosure committee would include overseeing and coordinating the collection of information, resolving questions about the materiality of a development, reviewing and advising on the content of disclosure, drafting of disclosure and communication with the investing public, and recommending to the board, the audit committee, the CFO and the CEO, the filing of the report.*

Purpose of Internal Control over Financial Reporting

The establishment, maintenance and periodic evaluation of Internal Control Over Financial Reporting required by Section 404 of the Act is important in view of the fact that in auditing financial statements, outside accountants conduct and rely upon samplings and random checks rather than upon an exhaustive review of each transaction. This method of sampling and spot checking is justified if a reliable system of Internal Controls Over Financial Reporting is in place because it provides a level of comfort that there are checks and balances which monitor the day to day financial operations of the company. If on the other hand, no reliable Internal Control Over Financial Reporting exists, the accountant would have to conduct tests of transactions and perform additional analyses in order to accumulate sufficient evidence to support its opinion on the financial statements.

1 Procedures To Be Included In the Internal Control Over Financial Reporting - *Internal Control Over Financial Reporting should include policies and procedures that provide reasonable assurance that (i) records are maintained that fairly reflect purchase and sales of the company's assets, (ii) that transactions are properly recorded so as to permit the preparation of GAAP financial statements, (iii) receipts and expenditures are being made in an authorized fashion and (iv) unauthorized use of company assets that could have a material effect on the financial statements will be timely detected.*

2 Extent of Management's Duty to Assess and Report on the Company's Internal Control Over Financial Reporting - *In order to ensure the reliability of the Internal Control Over Financial Reporting at all times, management is required to evaluate the effectiveness of those controls on a periodic basis and to include a report of such evaluation in the annual report, which evaluation must be attested to by the company's outside accountants. Under the Section 404 proposed rules, management would have been required to evaluate the effectiveness of the internal controls quarterly. Recognizing that this would be too burdensome, the June 5th Final Rules only require quarterly evaluation of changes that have materially affected, or are reasonably likely to materially affect, the Company's Internal Control Over Financial Reporting. Whereas a U.S. public company would have to report these changes quarterly, a non-U.S public company would only have to report them in its annual report.*

If, in the course of the evaluation, management discovers any deficiency in the design or operation of Internal Control Over Financial Reporting that could adversely affect a company's ability to record,

process, summarize and report financial data consistent with the assertions of management in the company's financial statements, then management must disclose this material weakness in the report.

3 Procedures To Be Followed by Management in Preparing the Report of the Effectiveness of Internal Control Over Financial Reporting - *The June 5th Final Rules do not specify the method or procedures to be performed in an evaluation and such method will vary from company to company. They do, however, require management to maintain the documentation that supports its assessment of the effectiveness of the company's Internal Control Over Financial Reporting. The documentation regarding the design of internal controls and the testing process should provide reasonable support (i) for the evaluation of whether the control is designed to prevent or detect material misstatement or omissions, (ii) for the conclusion that the tests were appropriately planned and performed and (iv) that the results of the tests were appropriately considered. In performing their evaluation of the design and effectiveness of the Internal Control Over Financial Reporting, management should review (i) the company's controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosures and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; controls relating to the selection and application of appropriate accounting policies and controls relating to the prevention, identification and detection of fraud.*

4 Location in the Annual Report of the Management's Report on the Effectiveness of Internal Control Over Financial Reporting - *Form 10-K for annual reports of U.S. public companies has been amended by adding Item 9A entitled "Controls and Procedures" to the annual report on Form 10-K. Form 20-F for annual reports for non-U.S. public companies has been amended by revising Item 15 of Part II. After the Second Compliance Date, these amendments will require a company's annual report to include an internal control report of management that contains (i) a statement of managements responsibility for establishing and maintaining internal controls over financial reporting for the company, (ii) a statement identifying the framework used by management to conduct the required evaluation (iii) managements assessment of the effectiveness of the company's Internal Control Over Financial Reporting as of the end of the company's most recent fiscal year, which assessment must include disclosure of any material weakness in the company's Internal Control Over Financial Reporting identified by management and (iv) a statement that the accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting, which report must be filed as part of the company's annual report with the SEC. For public companies that are Accelerated Filers, including non-U.S. public companies that are Accelerated Filers, the Second Compliance Date by which they must comply with the internal control report requirement is the date that the company files its first annual report for fiscal years ending on or after June 15, 2004. For public companies that are not Accelerated Filers, the Second Compliance Date by which they must comply with the internal control report requirement is the date that the company files its first annual report for fiscal years ending on or after April 15 2005.*

5 Framework To Be Adopted by Management in Evaluating the Internal Control Over Financial Reporting - *Although the SEC has not mandated any particular framework for the evaluation of the effectiveness of the Internal Control Over Financial Reporting, the framework used must be free of bias, permit qualitative and quantitative measurements, be sufficiently complete to include factors that would alter a conclusion about the effectiveness, and be relevant to an evaluation of internal control.*

3.44 Advanced Auditing and Professional Ethics

6 What Must the Outside Accountant's Attestation on Management's Internal Control Report Include and What Accounting Standards Will Be Used For Such Attestation?- *The June 5th Final Rules require each annual report to include an attestation by the company's outside accountants in which the accounting firm expresses an opinion, or states that an opinion cannot be expressed and if not, why not, about management's assessment of the effectiveness of the company's Internal Control Over Financial Reporting in accordance with standards on attestation engagements. The Act requires the new Public Company Accounting Oversight Board to establish standards for these attestation reports.*

7 Can Management Delegate the Evaluation of the Internal Control over Financial Reporting to the Company's Outside Accountants? - *Management cannot delegate the evaluation of the Internal Control Over Financial Reporting to the company's outside accountants because under the SEC's rules of auditor independence (see Carter Ledyard & Milburn's LLP client advisory dated May 2003 on Audit Committee and Financial Reporting for U.S. and non-U.S companies under the Sarbanes Oxley Act), one of the prohibited non-audit services that an outside accountant may not provide to its audit client is the monitoring of internal controls. Nevertheless, because under Section 404 of the Act, the outside accountant must attest to the effectiveness of management's evaluation of the internal controls, the outside accountant must be involved in the assessment. Accordingly, management must be actively involved in the evaluation of the internal controls by the outside accountants and coordinate the process with them.*

8 Do the Periodic Report Certification Requirements and the Controls and Procedures Apply to Non U.S Public Companies and to Current Reports on Form 8-K, Proxy Materials and Information Statements? - *It should be noted that the certification and Controls and Procedures apply to annual reports filed by Foreign Private issuers on Forms 20-F and 40-F. Although the certification is not required for reports of Foreign Private Issuers on Form 6-K, the Disclosure Controls and Procedures for generating a 6-K, especially those incorporating financial data, must be in place. These Controls and Procedures should be designed to ensure timely filing of Form 6-K reports via EDGAR (required since November 4, 2002) and to ensure that all information included in a Form 6-K is complete and accurate in all material respects.*

Current reports such as reports on Forms 8-K, 6-K, proxy materials and information statements are not covered by the Section 302 certification requirement. Disclosure Controls and Procedures for these reports however, are required to be designed, maintained and evaluated to ensure full and timely disclosure even though there is no certification requirement. In this connection, companies should build in to their Disclosure Controls and Procedures the mechanisms necessary to allow them to comply with a proposed amendment of the SEC which would require them to report on Form 8-K, 22 categories of events within two days of their occurrence.

[Certain materials of this section are sourced from Carter, Ledyard and Milburn LLP for which we acknowledge them with thanks]

4

Audit under Computerised Information System (CIS) Environment

4.1 Introduction

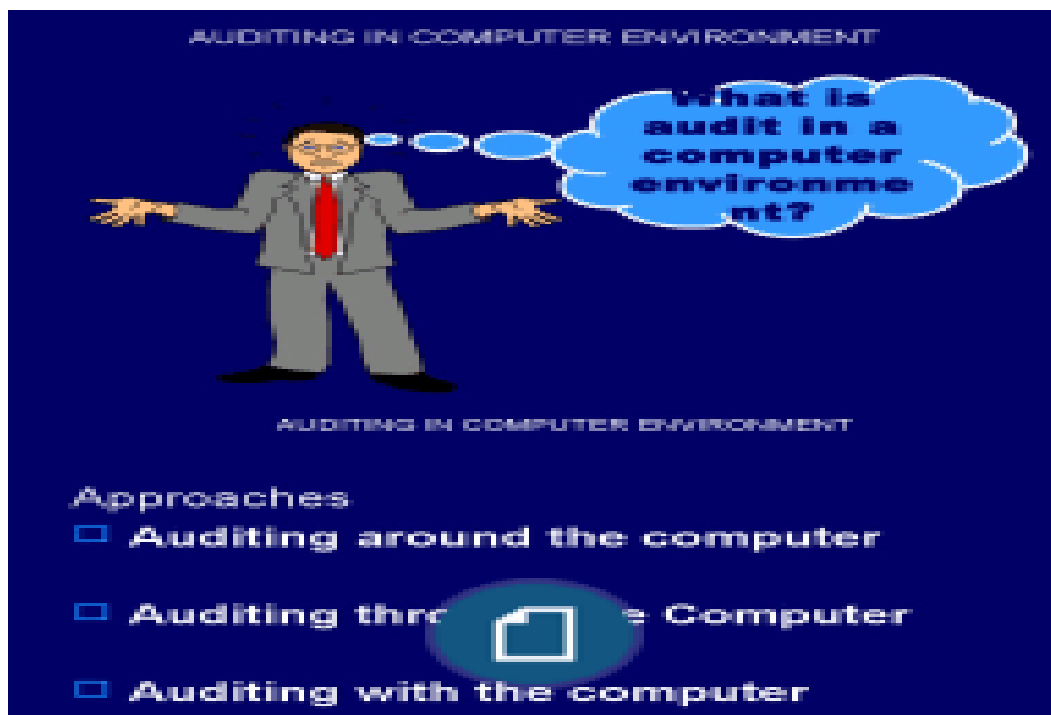


Fig.: What is Audit under Computerised Information System (CIS) Environment *

Information Technology throughout the world has revolutionized and dramatically changed the manner in which the business is conducted today. Computerization has a significant effect on organization control, flow of document information processing and so on. Auditing in a CIS environment even though has not changed the fundamental nature of auditing, it has definitely caused substantial changes in the method of evidence collection and evaluation. This also requires auditors to become knowledgeable about computer environment (Hardware, software etc.) and keep pace with rapidly changing technology, even to the extent of using sophisticated Audit

* Source: DocFoc.com

4.2 Advanced Auditing and Professional Ethics

software. Students are advised to study the technical issue relating to Information Technology from the study material of Paper 6 “Information Systems Control and Audit”.

4.2 Scope of Audit in a CIS Environment

Impact of computerisation on audit approach needs consideration of the following factors:

(1) High speed - In a CIS environment information can be generated very quickly. Even complex reports in specific report format can be generated for audit purposes without much loss of time. This cut down the time enabling the auditor to extend their analytical review for under coverage with high speed of operation, the Auditor can expand their substantive procedures for collection of more evidence in support of their judgement.

(2) Low clerical error - Computerised operation being a systematic and sequential programmed course of action the changes of commission of error is considerably reduced. Clerical error is highly minimised.

(3) Concentration of duties - In a manual environment the auditor needs to deploy separate individuals for carrying out the verification process. In a CIS environment, the traditional approach does not apply in many cases, as computer programs perform more than one set of activities at a time thereby concentrating the duties of several personnel involved in the work.

(4) Shifting of internal control base –

(i) Application systems development control - Systems development control should be designed to provide reasonable assurance that they are developed in an authorised and efficient manner, to establish control, over:

- (a) testing, conversion, implementation, and documentation of new revised system.
- (b) changes to application system.
- (c) access to system documentation.
- (d) acquisition of application system from third parties.

(ii) Systems software control - Systems software controls are designed to provide reasonable assurance that system software is acquired or developed in an authorised and efficient manner including:

- (a) authorisation, approval testing, implementation and documentation of new system software systems software modifications.
- (b) putting restriction of access to system software and documentation to authorised personnel.

(5) Disappearance of manual reasonableness - The shift from traditional manual information processing environment to computerised information systems environment needs a detailed analysis of the physical system for transformation into a logical platform. In creating such logical models many stages required under manual operations are either deleted or managed to create a focused computer system. In such creative effort, the manual reasonableness may be missing.

(6) Impact of poor system - If system analysis and designs falls short of expected standard of performance, a computerised information system environment may do more harm to integrated business operation than good. Thus, care has to be taken in adopting manual operations switch-over to computerised operations for ensuring performance quality standards.

(7) Exception reporting - This is a part of Management information system. Exception Reporting is a departure from straight reporting of all variables. Here the value of a variable is only reported if it lies outside some pre-determined normal range. This form of reporting and analysis is familiar to the accountant. The main strength of exception reporting lies in its recognition that to be effective information must be selectivity provided.

(8) Man-machine interface / human-computer interaction - Man-machine interface ensures maximum effectiveness of the information system. Organisation concentrated on presenting information that is required by the user and to present that information in the most uncluttered way. It is required to determine what information was necessary to achieve through a careful analysis of the job or task for which the user needed the information.

Human-computer interaction is a discipline concerned with the design, evaluation and implementation of interactive computing systems for human use and with the study of the major phenomena, surrounding them. The approach is user centered and integrates knowledge from a wide range of disciplines.

4.3 Impact of Changes on Business Processes (for shifting from Manual to Electronic Medium)

The effect of changes on accounting process may be stated as under:

A. Primary Changes

(1) Process of recording transactions - The process of recording transaction undergoes a major change when accounting process are computerised under CIS environment, the order of recording transaction from basic document to prime books and finally to principal book may not be followed strictly in sequential from as is observed in manual system. In many cases all the three processes Prime book of Entry, Ledger, Final accounts (Balance Sheet and Profit and Loss Account) are carried on simultaneously.

(2) Form of accounting records - Mechanisation often results in the abandonment in whole or in part of the primary records. Punch card installation or electronic data processor changes the form of both intermediate and ultimate records much more radically than manual records.

(3) Use of loose-leaf stationeries - Bound hand written records as used in manual accounting processes are replaced by loose-leaf machine written records in electronic medium. In a computerised information system, magnetic tapes, floppy disks, diskettes, print-outs replace the traditional records. This necessarily require proper control over such records to prevent their unauthorised use, destruction or substitution.

(4) Use of accounting code - In computerised information systems, alpha-numeric codes are extensively used to represent names and description. The accountants as well as the Auditors

4.4 Advanced Auditing and Professional Ethics

have to get themselves familiarised with the use of such codes which initially may pose considerable problems in understanding the various transactions.

(5) Absence of link between transaction – In a computerised information system environment, there may be an inadequacy or even total absence of cross-reference between the basic documents, primary records and the principal records. This creates special problems for the auditors. The auditors may find it difficult to trace a transaction from start to finish there by having a doubt in their mind as to loss of audit trails.

B. Recent Changes

The growth and development in the field of information technology is a fast paced one and unless the auditors are alert to such developments and take pre-emptive action in upgrading their knowledge, they may find difficulty in coping with such advancement.

Following are a few instances of the recent changes which may need to be addressed in discharging their responsibilities in such environment:

- (1) Mainframes are substituted by mini/micro users.
- (2) There is a shift from proprietary operating system to more universal ones like UNIX, LINUX, Programming in 'C' etc.
- (3) Relational Data Base Management (RDBMS) are increasingly being used.
- (4) The methodology adopted for systems development is becoming crucial and CASE (Computer Aided Software Engineering) tools are being used by many organisations.
- (5) End user computing is on the increase resulting in decentralized data processing.
- (6) The need for data communication and networking is increasing.
- (7) Common business documents are getting replaced by paperless electronic data interface (EDI).
- (8) Conventional data entry giving way to scanner, digitized image processes, voice recognition system etc.

The impact of all such change on auditing may be summarised as:

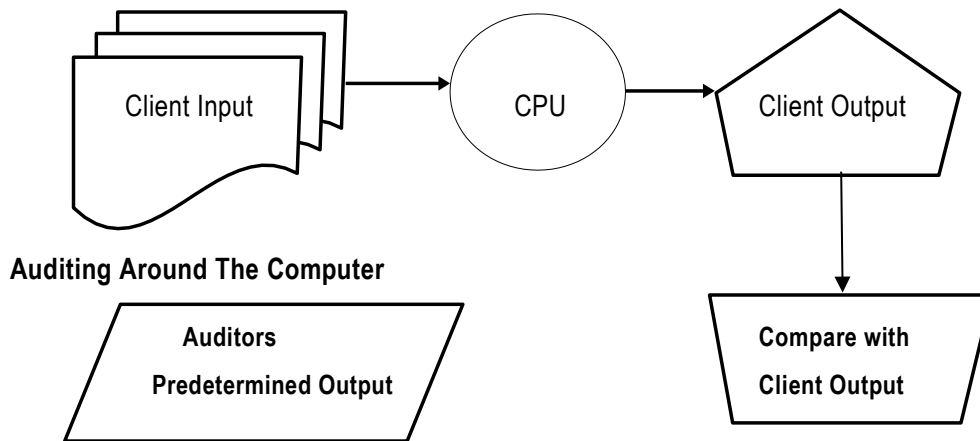
- (a) wide-spread end-user computing may result in unintentional errors creeping into systems owing to inept handling. Also coordinated program modification may not be possible.
- (b) improper use of decision support system can have serious repercussions. Also their underlying assumption must be clearly documented.
- (c) Usage of sophisticated audit software would be a necessity.
- (d) Auditors non-participation at System Development Life Cycle State (SDLC) pose considerable problem in understanding the operational controls.
- (e) Data communication and networking would introduce new audit risk.
- (f) The move toward paperless EDI would eliminate much of the traditional audit trail radically changing the nature of audit trails.

4.4 Audit Approaches in a CIS Environment

Based on The knowledge and expertise of Auditors in handling computerised data, the audit approach in a CIS environment could be either:

- A. A Black-box approach i.e., Auditing around the computer, or
- B. A White-box approach i.e., Auditing through the computer.

A. The Black Box Approach



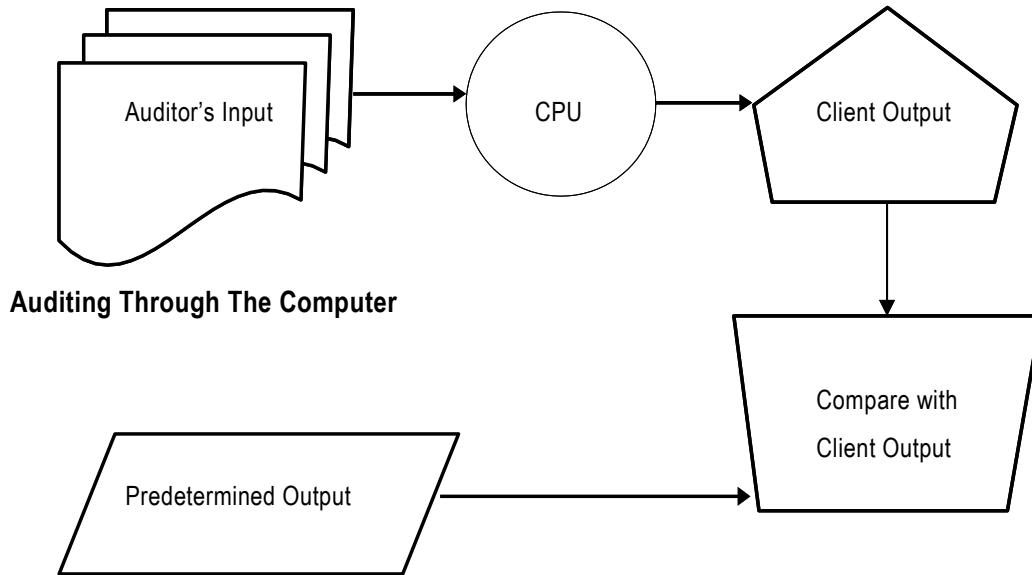
In the Black box approach or Auditing around the computer, the Auditor concentrates on input and output and ignores the specifics of how computer process the data or transactions. If input matches the output, the auditor assumes that the processing of transaction/data must have been correct.

In testing, say, Payroll Application, the auditor might first examine selected time cards for hours worked and employee earning cards for rates and then trace these to the payroll summary output and finally compare hours, rates and extensions. The comparison of inputs and outputs may be done manually with the assistance of the computer. The computer assisted approach has the advantage of permitting the auditor to make more comparisons than would be possible, if done manually.

Auditing around the computer has the advantage of ease of comprehension as the tracing of documents to output does not require any in-depth study of application program.

A major disadvantage, however, is that the auditor not having directly tested the control, cannot make assertions about the underlying process. Moreover, in some of the more complex computer systems intermediate printout may not be available for making the needed comparisons.

B. The White Box Approach



The processes and controls surrounding the subject are not only subject to audit but also the processing controls operating over this process are investigated. In order to help the auditor to gain access to these processes computer Audit software may be used. These packages may typically contain:

- (a) interactive enquiry facilities to interrogate files.
- (b) facilities to analyze computer security logs for unusual usage of the computer.
- (c) the ability to compare source and object (compiled) program codes in order to detect dissimilarities.
- (d) the facility to execute and observe the computer treatment of "live transaction" by moving through the processing as it occurs.
- (e) the generation of test data.
- (f) the generation of aids showing the logs of application programs. The actual controls and the higher level control will be evaluated and then subjected to compliance testing and, if necessary, substantive testing before an audit report is produced.

It is obvious, that to follow this approach the auditor needs to have sufficient knowledge of computers to plan, direct-supervise and review the work performed.

The areas covered in an audit will concentrate on the following controls:

- (1) Input controls,
- (2) Processing control,
- (3) Storage control,

- (4) Output control and
- (5) Data transmission control.

The auditor will also need to be satisfied that there are adequate controls over the prevention of unauthorised access to the computer and the computerised database. The auditor's task will also involve consideration of the separation of functions between staff involved in transaction processing and the computerised system and ensuring that adequate supervision of personnel is administered.

The process of auditing is not a straight forward flow of work from start to finish to be completed by satisfying oneself against a standard checklist or a list of questions. It involves exposure, experiences and application of knowledge and expertise to differing circumstances. No two information systems are the same. From the view point of analysis of a computerised information system, the auditor needs not only have adequacy of knowledge regarding information requirements and computer data security; they must also get exposed to system analysis and design so as to facilitate post implementation audit.

4.5 Effect of Computers on Internal Controls

Internal control systems include separation of duties, delegation of authority and responsibility, a system of authorisation, adequate documents and records, physical control over assets and records, management supervision, independent checks on performance and periodic reconciliation of assets with records. In a CIS environment, all these components must exist but computers affect the implementation of these internal controls in many ways. Some of the effects are as under:

(1) Segregation of Duties - In a manual system, different persons are responsible for carrying out functions like initiating, recording of transactions, safeguarding of assets, etc. This does not always apply in a computer system. For example, in a computer system, a program may carry out reconciliation of vendor invoices against a receipt document and also prepare a cheque payable to trade payables. Such operations through a program will be considered as incompatible functions in a manual system.

In minicomputer and microcomputer environments, separation of incompatible functions could be even more difficult. Some such programs allow users to change programs and data entry without providing a record of these changes. Thus, it becomes difficult to determine whether incompatible functions have been performed by system users.

(2) Delegation of Authority and Responsibility - A structured authority and responsibility is an essential control within manual and computer environments. In a computer system however, a clear line of authority and responsibility might be difficult to establish because some resources are shared among multiple users. For instance, one objective of using a database management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data, when multiple users have access to the same data and the integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organisations identify a single user as the owner of the data.

(3) Competent and Trustworthy Personnel - Skilled, competent, well-trained and experienced information system personnel have been in short supply. Since substantial power is often vested in the person responsible for the computer information system development, implementation, operation and maintenance within the organisation, competent and trustworthy personnel is very much in demand. Unfortunately, the non availability of competent personnel, forced many organisation to compromise on their choice of staff. Moreover, it is not always easy for organisation to assess the competence and integrity of their system staff. High turnover among those staff has been the norm. Some information systems personnel lack a well developed sense of ethics and some enjoy in subverting controls.

(4) System of Authorisation - Management authorisation of transaction may be either:

- (a) general authorisation to establish policies for the organisation,
- (b) specific authorisation applying to individual transactions. In manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, authorisation procedures often are embedded within a computer program. In a computer system, it is also more difficult to assess whether the authority assigned to individual persons is constant with managements policies. Thus, in evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of the programme processing.

(5) Adequate Documents and Records - In a manual system, adequate documents and records are required to provide an audit trail of activities within the system. In computer system, document support might not be necessary to initiate, execute and records some transaction. The task of a visible audit trail is not a problem for auditors, provided the systems have been designed to maintain a record of all events and that they are easily accessible. In well-designed computer systems, audit trails are more extensive than those maintained in manual systems unfortunately not all computer systems are well designed. This creates a serious control problem.

(6) Physical Control over Assets and Records - Physical access to assets and records is critical in both manual systems and computer system. In a computer system the information system assets and records may be concentrated at a single site. The concentration of information systems assets and record also increases the losses that can arise from computer abuse or disaster. If the organisation does not have another suitable backup, it might be unable to continue operations.

(7) Adequate Management Supervision - In a computer system, supervision of employee might have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and in inquiring computer system also make the activities of employees less visible to management. Because many activities are electronically controlled managers must periodically access the audit trial of employee activities and examine it for unauthorised actions.

(8) Independent Checks On Performance - Checks by an independent person help to detect any errors or irregularities. In a computer system, if a program code is authorised accurate, and complete the system will always follow the laid down procedures in absence of other type of

failures like hardware or systems software failure. Thus, independent checks on the performance of programs often have little value. Instead, the control emphasis shifts to ensuring the veracity of programme code. Auditors must now evaluate the controls established for program development, modification operation and maintenance.

(9) Comparing Recorded Accountability with Assets - In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system software is used to prepare this data. If unauthorised modifications occur to the program or the data files that the program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

4.6 Effects of Computers on Auditing

The objective of auditing, do not undergo a sea change in a CIS environment. Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:

(1) Changes to Evidence Collection - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:

- (a) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,
- (b) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused on cryptographic controls to protect the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection

(2) Changes to Evidence Evaluation - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

4.10 Advanced Auditing and Professional Ethics

Auditors need to understand:

- (a) whether a control is functioning reliably or multi functioning,
- (b) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequences of errors in a computer system are a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

4.7 Internal Controls in a CIS Environment

Internal control is an essential prerequisite for efficient and effective management of any organisation. Basically, they are the policies and procedure adopted by a management to achieve the entity's specific objectives like, physical verification of assets, periodic review and reconciliation of accounts, specific control on computer generated data etc.

An internal control in a CIS system depends on the same principal as that of manual system. Thus, the plan of organisation, delegation of powers, system authorisation, distribution of duties etc., are determined on similar consideration as in a manual system. However, in a CIS environment, due to difference in approach there is various other types of controls which are quite specific to CIS environment.

In setting up an internal control system in a CIS environment, the overall CIS operation need to be broken down into defined subsystem and controls established accordingly, addressing each function separately so that auditors can place reliance on them. The basic components that can be identified in a CIS environment are:

- ◆ Hardware (CPU, Monitor, Printers etc.)
- ◆ Software (Operating system, application programs, Data base management system etc.)
- ◆ People (Data entry operator, CIS organisation, end users)
- ◆ Transmission media

Once components have been identified, auditors must evaluate their reliability with respect to each type of error or irregularity that might occur.

The reliability of a component is a function of the controls that act on the component. A control is stated to be a set of activities designed to prevent, detect or correct errors or irregularities that affect the reliability of the components. The set of all control activities performed in a system constitutes the control subsystem within a system. Its function is to establish execute modify and maintain control activities so that the reliability of the system is maintained at an acceptable

level. In a computer system many different types of controls are used to enhance component reliability. Major classes of control that the auditor must evaluate are:

(1) Authenticity Controls - Authenticity control are exercised to verify the identity of the individuals or process involved in a system (e.g. password control, personal identification numbers, digital signatures).

(2) Accuracy Control - Accuracy control ensure the correctness of data and processes in a system (e.g. program validation check that a numeric field contains only numeric, overflow checks, control totals, hash total etc.).

(3) Completeness Control - Completeness control attempt to ensure that no data is missing and that all processing is carried through to its proper conclusion (e.g. program validation check, sequence check etc.).

(4) Redundancy Control - Redundancy controls attempts to ensure that a data is processed only once (e.g. batch cancellation stamp, circulating error files etc.).

(5) Privacy Controls - Privacy controls ensure that data is protected from inadvertent or unauthorised disclosure (e.g. cryptograph, data compaction, inference control etc.).

(6) Audit Trail Controls - Audit trail control ensure traceability of all events occurred in a system. This record is needed to answer queries, fulfil statutory requirements, minimise irregularities, detect the consequences of error etc. The accounting audit trail shows the source and nature of data and process that update the database. The operations audit trail maintains a record of attempted or actual resource consumption within a system.

(7) Existence Controls - Existence controls attempt to ensure the ongoing avail ability of all system resources (e.g., database dump and logs for recovery purposes duplicate hardware, preventive maintenance, check point and restart control).

(8) Asset Safeguarding Controls - Asset safeguarding control attempt to ensure that all resources within a system are protected from destruction or corruption (e.g. physical barriers, libraries etc.).

(9) Effectiveness Controls - Effectiveness control attempt to ensure that systems achieve their goals (e.g. monitoring of user satisfaction, post audits, periodic cost benefit analysis etc.).

(10) Efficiency Controls - Efficiency controls attempt to ensure that a system uses minimum resources to achieve its goals.

4.8 Consideration of Control Attributes by the Auditors

In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control. Some of the attributes are:

- (1) whether the control is in place and is functioning as desired.
- (2) generality versus specificity of the control with respect to the various types of errors and irregularities that might occur.

General control inhibit the effect of a wide variety of errors and irregularities as they are more robust to change controls in the application sub-system which tend to be specific control because component in these sub-system execute activities having less variety.

4.12 Advanced Auditing and Professional Ethics

- (3) Whether the control acts to prevent, detect or correct errors.

The auditor focuses here on-

- (i) Preventive controls: Controls which stop errors or irregularities from occurring.
- (ii) Detective controls: Controls which identify errors and irregularities after they occur.
- (iii) Corrective controls: Controls which remove the effects of errors and irregularities after they have been identified.

Auditors expect to see a higher density of preventive controls at the early stages of processing or conversely they expect to see more detective and corrective controls later in system processing.

- (4) The number of components used to execute the control.

Multi-component controls are more complex and more error prone but they are usually used to handle complex errors and irregularities.

4.9 Internal Control Requirement under CIS Environment

The requirement of internal control under CIS environment may cover the following aspects:

(1) Organisation and Management Control - Controls are designed to establish an organisational frame work for CIS activities including:

- (a) Policies and procedures relating to control functions.
- (b) Appropriate segregation of incompatible functions.

(2) Application System Development and Maintenance Control - Control are designed to provide reasonable assurance that systems are developed and maintained in an authorised and efficient manner, to establish control over:

- (a) testing, conversion, implementation and documentation of new revised system.
- (b) changes made to application system.
- (c) access to system documentation.
- (d) acquisition of application system from third parties.

(3) Computer Operation Controls - Designed to control the operation of the system and to provide reasonable assurance that:

- (a) the systems are used for authorised purposes only.
- (b) access to computer operation is restricted to authorised personnel.
- (c) only authorised programs are to be used.
- (d) processing errors are detected and corrected.

(4) System Software Control - Controls are designed to provide reasonable assurance that system software is acquired or developed in an authorised and efficient manner including:

- (a) authorisation, approval, testing, implementation and documentation of new system software and system software modification.

- (b) restriction of access to system software and documentation to authorised personnel.
- (5) Data Entry and Program Control** - Designed to provide assurance:
 - (a) an authorisation structure is established over transaction being entered into the system.
 - (b) access to data and program is restricted to authorised personnel.
- (6) Control over Input** - Control are designed to provide reasonable assurance that:
 - (a) transactions are properly authorised before being processed by the computer.
 - (b) transactions are accurately converted into machine readable form and recorded in the computer data files.
 - (c) transaction are not lost, added, duplicated or improperly changed.
 - (d) incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.
- (7) Control over Processing and Computer Data Files** - Controls are designed to provide reasonable assurance that:
 - (a) transactions including system generated transactions are properly processed by the computer.
 - (b) transaction are not lost, added duplicated or improperly changed.
 - (c) processing errors are identified and corrected on a timely basis.
- (8) Control over Output** - Designed to provide reasonable assurance that
 - (a) results of processing are accurate.
 - (b) access to output is restricted to authorised personnel.
 - (c) output is provided to appropriate authorised personnel on a timely basis.
- (9) Other Safeguards** - Other safeguards include:
 - (a) Offsite back-up of data and program.
 - (b) Recovery procedures for use in the event of theft, loss or intentional or accidental destruction.
 - (c) Provision of offsite processing in the event of disaster.

4.10 Auditing in a CIS Environment

Auditing in a computer Information System Environment emphasis that, the overall objective and scope of an audit do not change in a CIS environment. However, the use a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity.

The auditor should consider the effect of the factor like, (a) the extent of use of computers for preparing accounting information (c) efficacy of internal control over input, processing, analysis and reporting undertaken in the CIS installation and (c) the impact of computerisation on the audit trail that could otherwise be expected to exist in a manual system.

4.14 Advanced Auditing and Professional Ethics

The approach to auditing in a CIS environment provides for the following:

(1) Skill and Competence - An auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the CIS environment. The auditor should consider whether any specialized CIS skills are needed in the conduct of the audit. If the answer is in affirmative the auditor would seek the assistance of an expert possessing such skills.

(2) Planning - In regard to planning, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of the data for use in the audit.

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

Auditors understanding the process would include -

- (a) The computer information systems infrastructure (hardware, operating system (s) and application software used by the entity, including changes therein since last audit, if any).
 - (b) The significance and complexity of computerized processing in each significant accounting application, Significance relates to materiality of the financial statement assertions affected by the computerized processing.
 - (c) Determination of the organizational structure of the client; CIS activities and the extent of concentration or distribution of computer processing throughout the entity, particularly, as they may affect segregation of duties.
 - (d) The auditor needs to determine extent of availability of data by reference to source documents, computer files and other evidential matters. Computer information systems may generate reports that might be useful in performing substantive tests (particularly analytical procedures). The potential for use of CAATS may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of transactions.
- (3) Risk** - When the computer information systems are significant the auditor should assess whether it may influence the assessment of inherent and control risks.

The nature of the risks and the ICS in CIS environment include the following:

- (a) **Lack of Transaction Trails** - Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly errors embedded in an application's program logic may be difficult to detect on a timely basis by manual procedures.
- (b) **Uniform processing of Transactions** - Computer programs processing transactions uniformly, virtually eliminating the occurrence of clerical errors. However, if programming error exists all transactions will be processed incorrectly.

- (c) **Lack of Segregation of functions** - Many controls becomes concentrated in a CIS environment allowing data processing of incompatible functions.
- (d) **Potential for errors and Irregularities** - The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorized access to data or to alter data without visible evidence may be greater in CIS environment than in manual systems.
- (e) **Initiation or Execution of Transactions** - In a CIS process certain types of transactions are triggered internally by the system, the authorization for which may not be documented as in manual system. In such cases, management; authorization of these transactions may be implicit.
- (f) **Dependence of Other Controls over Computer Processing** - Certain manual control procedures are dependent on computer generated reports and outputs for their effectiveness. In term, the effectiveness and consistency of transaction processing controls are dependent on the effectiveness of general computer information systems controls.
- (g) **Increased management Supervision** - Computer information can offer management a variety of analytical tools that can enhance the effectiveness of the entire internal control structure.
- (h) **Use of Computer - Assisted Audit Techniques** - The Auditor may apply general or specialized computer audit techniques and tools in the execution of audit tests.

While evaluating the reliability of the accounting and internal control systems, the auditor would consider whether these systems:

- (i) Ensure that authorized, correct and complete data is made available for processing;
- (ii) Provide for timely detection and correction of errors;
- (iii) Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;
- (iv) Ensure that accuracy and completeness of output;
- (v) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.;
- (vi) Prevent unauthorized amendments to the program;
- (vii) Provide for safe custody of source code of application software and data files.

(4) Risk Assessment - The auditor in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", should make an assessment of inherent and control risk for material financial statement assertions.

Risk may result from deficiencies in-

- (a) Program development and maintenance;

4.16 Advanced Auditing and Professional Ethics

- (b) System software support;
- (c) Operations;
- (d) Physical CIS security;
- (e) Control over access to specialized utility programs.

These deficiencies would tend to have a negative impact on all application systems that are processed through the computer.

Risk may also increase the potential for errors or fraudulent activities in-

- (a) Specific applications,
- (b) Specific data base or master files, or
- (c) Specific processing activities.

As new CIS technologies are emerging for data processing and Clients are adopting the same for building complex computer systems, these may increase risk which needs further consideration.

(5) Documentation - The Auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. In an audit in CIS environment, some of the audit evidence may be in electronic form. The auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.

4.11 Review of Checks and Controls in a CIS Environment

General controls in a CIS environment falls under the three basic control approaches as seen under manual system, i.e. Feedback, feed-forward and preventive control. Apart from the three - fold categorization computer based information system also required different controls, though the emphasis is on preventive controls, Controls are present over many aspects of the computer system and its surrounding social environment. They operate over data moving into, through and out of the computer to ensure correct, complete and reliable processing and storage. There are other controls present over staff, staff involvement with the computer and access to data. Further controls are effective at preventing deterioration or collapse of the entire computing function.

Erroneous data processing by a computer system is likely to be the result of incorrect data input. This is the major point at which the human interfaces with the machine and it is here where important controls are placed.

Review Process -

(1) Organization Structure / Control - CIS function in an organization need to be so organized that different groups are formed to perform different duties in a large CIS installation. Some of the typical function that must be performed by select group includes:

- (a) Data Administrator** - Generates the data requirements of the users of information system services: formulates data policies, plans the evaluation of the corporate data bases, maintains data documentation.

- (b) **Database Administrator** - Responsible for the operational efficiency of corporate database, assist users to use database better.
- (c) **System Analyst** - Manages information requirement for new and existing applications, designs information systems architectures to meet these requirements, facilitates implementation of information systems, writes procedures and users documentation.
- (d) **System Programmers** - Maintains and enhances operating systems software, network software, library software, and utility software, provides when unusual systems failure occurs.
- (e) **Application Programmer** - Designs programs to meet information requirements, codes, tests and debugs programs documents programs, modify program to remove errors, improve efficiency.
- (f) **Operation Specialist** - Plans and control day-to-day operations, monitors and improves operational efficiency along with capacity planning.
- (g) **Librarian** - Maintains library of magnetic media and documentation.

Auditors should be concerned about two matters:

- (i) Responsibilities of each job position must be clear; and incumbents must fully understand their duties, authority and responsibilities.
- (ii) The jobs performed within the information system function should maintain separation of duties to the extent possible. Without separation of duties, errors and irregularities might remain undetected.

(2) **Documentation Control** - Systems and programs as well as modifications, must be adequately documented and properly approved before being used: Documentation ordinarily assumes the following form:

- (a) A system flowchart;
- (b) A program flowchart;
- (c) Program change;
- (d) Operator instructions;
- (e) Program description (explaining the purpose for each part of the program).

Adequate documentation evidencing approval of changes minimises the probability of unauthorized system and program changes that could result in loss of control and decreased reliability of financial data.

(3) **Access Control** - Access controls are usually aimed at for preventing unauthorized access. The controls may seek to prevent persons who are authorised for access from accessing restricted data and program, as well as preventing unauthorized persons from gaining access to the system as a whole.

(a) **Segregation Controls**

- ◆ Access to program documentation should be limited to those persons who require it in the performance of their duties.

4.18 Advanced Auditing and Professional Ethics

- ◆ Access to data files and programs should be limited to those individuals authorized to process data.
 - ◆ Access to computer hardware should be limited to authorized individuals (e.g. Computer operators).
- (b) Limited Physical Access to the computer Facility**
- ◆ The physical facilities that hold the computer equipment, files and documentation should have controls to limit access only to authorized individuals.
 - ◆ Types of controls may include, (a) using a guard, (b) automated key cards, (c) manual key locks, (d) new access devices like, fingerprints, palm prints, or other biometric devices.
- (c) Visitor entry Logs** - Entry logs should be used to determine and document those who have had access to the area.
- (d) Hardware and Software access controls** - Access control software like 'user identification' may be used. User identification is a frequently used control and is a combination of a unique identification code and a confidential password.
- (e) Call back** - It is a specialized form of user identification in which the user dials the system, identifies him and is disconnected from the system. Then, either an individual manually finds the authorized telephone number or the system automatically finds the authorized telephone number of the individual and finally the user is called back.
- (f) Encryption** - In encryption data is encoded when stored in computer files / and or before transmission to or from remote locations. This coding protects data because to use the data unauthorized users must not only obtain access, but must also decrypt the data i.e., decode it from encoded form.
- (g) Computer Application Controls** - Programmed application controls apply to specific application rather than multiple applications.

These controls operate to assure the proper input and processing of data. The input step converts human readable data into computer readable form. All CIS applications are classified under 3 heads: Input, Processing and output.

(4) Input Controls - Input into the CIS system should be properly authorized and approved. The system should verify all significant data fields used to record information i.e., Should perform editing of the data. Conversion of data into machine readable form should be controlled and verified for accuracy.

For validation of input controls, the following procedure can be applied:

- (a) Pre-printed form** - All constant information be printed on a source document. For example, if only limited number of responses to a question is considered appropriate then preprint the responses and have the user tick or circle the correct responses deleting those that are inappropriate.
- (b) Check Digit** - Errors made in transcribing and keying data can have serious consequences. One control used to guard against these types of errors is a 'Check Digit'.

A Check Digit is a redundant digit (s) added to a code that enables the accuracy of other characters in the code to be checked. The check digit can act as a prefix or suffix character or it can be placed somewhere in the middle of the code. When the code is entered, a program recalculates the check digit to determine whether the entered check digit and the calculated check digit are the same. If they are the same, the code is most likely to be correct.

Calculation of Check Digit

A simple way is to add the digits in a number and assign the result as a suffix.

Example: The number is 2148 the check digit is

$2+1+4+8=15$ i.e., 5 (dropping tens digit). The code is 21485

However, this does not protect transposition error, like 2814. The incorrect code will still produce the correct check digit.

This problem can be overcome by Module -11 test. The Calculation steps are as under:

- The desired number = 2148.
- Make weighed average = $2 \times 5 + 1 \times 4 + 4 \times 3 + 8 \times 2 = 42$
- Divide by Modules 11 = $42/11$ -3 with remainder 9
- Subtract the remainder from the modules = $11-9 = 2$ (check digit)
- Check digit is added as a suffix = 21482.

The check digit can be recalculated for verification as under:

- The encoded number = 21482
- Weighted average = $(2 \times 1) + (8 \times 2) + (4 \times 3) + (1 \times 4) + (2 \times 5) = 44$.
- Division by the modules = $44/11 = 4$ with no remainder.

If the remainder is zero, there is a high probability that the code is correct.

- (c) **Completeness Totals** - To input data erroneously is one type error. To leave out or lose data completely is another type of error against which controls are provided.
- (i) **Batch Control Totals** - The transactions are collected together in batches of say, 50 transactions. A total of all the data value of some important field is made. For example, if a batch of invoices is to be imputed a total of all the invoices amounts might be calculated manually. The control total is then compared with a computer generated control total, after input of batch transaction. A difference indicates either a lost transaction or the input of an incorrect invoice total. The method is not fool proof as compensating errors is possible.
 - (ii) **Batch Hash Total** - The idea is similar to control totals except that Hash totals are meaningless totals prepared purely for control purposes. The total of all customer account numbers in a batch is meaningless but may be used for control by comparing it with computer generated hash totals.
 - (iii) **Batch Record Totals** - Account is taken of the number of transactions and this is compared with the record count produced by the computer at the end of the batch.

4.20 Advanced Auditing and Professional Ethics

- (iv) **Sequence Checks** - Documents may be pre-numbered sequentially before entry and at a later stage the computer will perform a sequence check and display any missing number.
- (d) **Reasonableness Checks** - These are sophisticated forms of limit checks. An example might be a check on an electricity meter reading. The check might consist of subtracting the last reading recorded from the current reading and comparing this with the average usage for that quarter. If the reading differs by a given percentage then it is investigated before processing.
- (e) **Field Checks** - The following types of field checks may be applied:
 - (i) **Missing data / blank** - Is there any missing data in the field? If a code should contain 2 hyphens, though they might be in a variable position, can only one be detected? Does the field contain blanks when data always should be present?
 - (ii) **Alphabetic / Numeric** - Does a field that should contain only alphabetic or numeric contain alphanumeric characters?
 - (iii) **Range** - Does the data for a field fall within its allowable value range?
 - (iv) **Master Reference** - If the master file can be referenced at the same time input data is read, is there a master file match for the key field?
 - (v) **Size** - If variable - length fields are used and a set of permissible sizes is defined does the field delimiter show the field to be one of these valid sizes?
 - (vi) **Format Mask** - Data entered into a field might have to conform to a particular format, like 'yy mm dd'.
- (f) **Record Checks** - The following types of record checks can be applied:
 - (i) **Reasonableness** - Even though a field value might pass a range check, the contents of another field might determine what is a reasonable value for the field.
 - (ii) **Valid-Sign-Numeric** - The content of one field might determine which sign is valid for a numeric field.
 - (iii) **Size** - If Variable - length records are used, the size of the record is a function of the sizes of the variable length fields or the sizes of fields that optionally might be omitted from the record. The permissible size of the fixed and variable - length records also might depend on a field indicating the record type.
- (g) **File Checks** - In file checks, validation control examines whether the characteristics of a file used during data entry are matching with the stated characteristics of the file. For example if auditors validate some of the characteristic of data that is keyed into an application system against a master file, they can check whether they are using the latest version of the master file.
- (5) **Processing Controls** - When input has been accepted by the computer, it usually is processed through multiple steps. Processing controls are essential to ensure the integrity of data. Almost all of the controls mentioned under input may also be incorporated during processing stage.

Processing validation checks primarily ensure that computation performed on numeric fields are authorized, accurate, and complete. The following validation checks may be indicated in this regard.

- (i) **Overflow** - Overflow can occur if a field used for computation is not initiated to zero at start. Some error in computation occurs, or unexpected high values occur.
- (ii) **Range** - An allowable value range can apply to a field.
- (iii) **Sign Test** - The contents of one record type field might determine which sign is valid for a numeric field.
- (iv) **Cross – Footing** - Separate control totals can be developed for related fields and cross footed at the end of a run.
- (v) **Run-to-Run Control** - In a tape based system, the processing of transaction file may involve several runs, for instance, a tape based order processing system might have a transaction tape that is used to update first a inventory master file, then a sales ledger followed by a general ledger, various control totals may be passed from one run to the next as a check on completeness of processing.
- (6) **Recording Control** - Recording controls enable records to be kept free of errors and transactions details that are input into the system.
 - (a) **Error Log** - This is particularly important in batch entry and batch processing system. Many of the accuracy checks can only be carried to during run time processing. It is important that a detected error does not bring the run to a halt, on discovery, the erroneous transaction is written to a error log file, which is examined at the end of processing. The errors can then be corrected or investigated with the relevant department before being input and processed.
 - (b) **Transaction Log** - The transaction log provides a record of all transactions entered into the system as well as storing transaction details such as the transaction reference number, the date, the account number, the type of transaction the amount and the debit and credit references. The transaction will be "Stamped" with details of input. These typically include input time, input date, input day, terminal number and user number. It is used for multi-access main frame systems accounting transactions. The transaction log can form the basis of an audit trail and may be printed out for investigation during an audit.
- (7) **Storage Control** - These controls ensure the accurate and continuing and reliable storage of data. Data is a vital resource for an organization and is the heart of CIS activities. Special care must be taken to ensure the integrity of the database or file system. The controls are particularly accidental erasure of files and the precision of back-up and recovery facilities.

The following checks may be considered:

- (a) **Physical Protection against Erasure** - Magnetic tape files have rings that may be inserted if the files are to be written or erased. Read only files have the ring removed. The controls in respect of floppy disks have a plastic lever, which is switched for read only purposes.

- (b) **External Label** - These are attached to tape reels or disk packs to identify the contents.
- (c) **Magnetic Labels** - These consists of magnetic machine readable information encoded on the storage medium identifying its contents. File header labels appear at the start of a file and identify the file by name, give the date of last update and other information. This is checked by software prior to file up dating. Trailer labels at the end of files often contain controls that are checked against those calculated during file processing.
- (d) **File Back-up Routines** - Copies are held of important files for security purposes. As the process of providing back-up often involves a computer operation in which one file is used to produce another, a fault in this process would have disastrous results; if both the master and the back-up were lost.
- (e) **Database Back-up routines** - The contents of a data base held on a direct access storage device (DASD) such as magnetic disk are periodically dumped on to a back-up file. The back-up is usually a tape which is then stored together with the transaction log tape of all transactions occurring between the last and the current dump. If a fault in database, such as disk crash, happens afterwards the state of the data base can be recreated using the dumped data base tape, the stored transaction and the current log of transactions occurring between the dump and the crash point.
- (f) **Cryptographic Storage** - Data is commonly written to files in a way that uses standard coding like ASCII or EBCDIC. It can be interpreted easily by unauthorized reader gaining access to the file. If the data is confidential or sensitive then it may be scrambled prior to storage and described on reading.

The security process involves the conversion of the plain text message or data into cipher text by the use of an encryption algorithm and an encryption key. The opposite process uses a description key to reproduce the plain text or message. If the encryption and decryption key are identical the entire procedure is called Symmetric Cryptograph, otherwise, it is known as asymmetric cryptograph.

(8) **Output Control** - Output control ensures that the results of data processing are accurate, complete and are directed to authorize recipient. The auditor should examine whether audit trail relating to output was provided and the date and time when the output was so provided. This would enable the auditor to identify the consequences of any errors discovered in the output.

4.12 Computer Assisted Audit Techniques (CAATS)

The overall objectives and scope of an audit do not change when an audit is conducted in a Computer Information Systems (CIS) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems.

Uses of CAATs - CAATs may be used in performing various auditing procedures, including the following:

- ◆ tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
- ◆ analytical procedures, for example, identifying inconsistencies or significant fluctuations;
- ◆ tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;
- ◆ sampling programs to extract data for audit testing;
- ◆ tests of application controls, for example, testing the functioning of a programmed control; and
- ◆ reperforming calculations performed by the entity's accounting systems.

Audit Software - CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software, and perform audit tests more efficiently. CAATs may consist of package programs, purpose-written programs, utility programs or system management program. A brief description of the programs commonly used is given below:

- ◆ Package Programs are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- ◆ Purpose-Written Programs perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
- ◆ Utility Programs are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- ◆ System Management Programs are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Considerations in the Use of CAATs - When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques. In determining whether to use CAATs, the factors to consider include:

- ◆ the IT knowledge, expertise and experience of the audit team;
- ◆ the availability of CAATs and suitable computer facilities and data;
- ◆ the impracticability of manual tests;
- ◆ effectiveness and efficiency; and

4.24 Advanced Auditing and Professional Ethics

- ◆ time constraints.

Before using CAATs the auditor considers the controls incorporated in the design of the entity's computer systems to which CAAT would be applied in order to determine whether, and if so, how, CAATs should be used.

It Knowledge, Expertise And Experience of The Audit Team: Auditing in a computer information systems environment deals with the level of skill and competence the audit team needs to conduct an audit in a cis environment. It provides guidance when an auditor delegates work to assistants with CIS skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on "availability of CAATs" and "suitable computer facilities".

Availability of CAATS and Suitable Computer Facilities - The auditor considers the availability of CAATs, suitable computer facilities and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package program and entity's computer. Additionally, the auditor may elect to use their own facilities, such as pcs or laptops. The cooperation of the entity's personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of CAAT on the entity's system, and to provide copies of data files in the format required by the auditor.

- ◆ **Impracticability of Manual Tests -** Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.

Effectiveness and Efficiency - The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:

- ◆ analyzing and selecting samples from a large volume of transactions;
- ◆ applying analytical procedures; and
- ◆ performing substantive procedures.

Matters relating to efficiency that an auditor might consider include:

- ◆ the time taken to plan, design, execute and evaluate CAAT;
- ◆ technical review and assistance hours;
- ◆ designing and printing of forms (for example, confirmations); and
- ◆ availability of computer resources.

In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application. The initial planning, design and development of CAAT will usually benefit audits in subsequent periods.

Time Constraints

Certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

Where the time available to perform an audit is limited, the auditor may plan to use CAAT because its use will meet the auditor's time requirement better than other possible procedures.

Using CAATs - The major steps to be undertaken by the auditor in the application of CAAT are to:

- (a) set the objective of CAAT application;
- (b) determine the content and accessibility of the entity's files;
- (c) identify the specific files or databases to be examined;
- (d) understand the relationship between the data tables where a database is to be examined;
- (e) define the specific tests or procedures and related transactions and balances affected;
- (f) define the output requirements;
- (g) arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
- (h) identify the personnel who may participate in the design and application of CAAT;
- (i) refine the estimates of costs and benefits;
- (j) ensure that the use of CAAT is properly controlled;
- (k) arrange the administrative activities, including the necessary skills and computer facilities;
- (l) reconcile data to be used for CAAT with the accounting and other records;
- (m) execute CAAT application;
- (n) evaluate the results;
- (o) document CAATs to be used including objectives, high level flowcharts and run instructions; and
- (p) assess the effect of changes to the programs/system on the use of CAAT.

Testing CAAT - The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. This should be done before reliance is placed upon CAAT. The nature, timing and extent of testing are dependent on the commercial availability and stability of CAAT.

Controlling CAAT Application - The specific procedures necessary to control the use of CAAT depend on the particular application. In establishing control, the auditor considers the need to:

4.26 Advanced Auditing and Professional Ethics

- (a) approve specifications and conduct a review of the work to be performed by CAAT;
- (b) review the entity's general controls that may contribute to the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and
- (c) ensure appropriate integration of the output by the auditor into the audit process.

Procedures carried out by the auditor to control CAATs applications may include:

- (a) participating in the design and testing of CAAT;
- (b) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;
- (c) asking the entity's staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;
- (d) running the audit software on small test files before running it on the main data files;
- (e) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;
- (f) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and
- (g) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When the auditor intends to perform audit procedures concurrently with online processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.

Special Audit Techniques

5.1 Introduction

Normally, an audit programme specifies the techniques to be employed in the specific case by relating the techniques to the respective areas of accounting. Chapter 3 of the Intermediate (IPC) Course Study Material contains various techniques generally employed for auditing the books of account. For example, the techniques of posting, checking and casting all related to the subsidiary books of account and the principal books of account. Vouching will be in respect of all the transactions whether appearing in the cash book or in any journal. The confirmation technique is appropriate in relation to personal accounts balances, bank balances or securities lodged with others. In this Chapter, we shall deal with some of these techniques in greater detail.

5.1.1 Confirmation

It is a method of collecting audit evidence which consists of the response to an inquiry to corroborate information contained in the accounting records. It may be interesting to note that the AICPA included direct confirmation of sundry debtors in its Auditing Standards after the decision of Mckesson and Robbins. Same procedure is applicable in case of creditors as well. For example, the auditor requests confirmation of receivable by direct communication with debtors. The Guidance Note on Audit of Sundry Debtors, Loans and Advances issued by the Institute of Chartered Accountants of India has recommended that balances outstanding against debtors and as loan and advances should be confirmed by a procedure of communication with the parties. The Guidance Note provides the following:

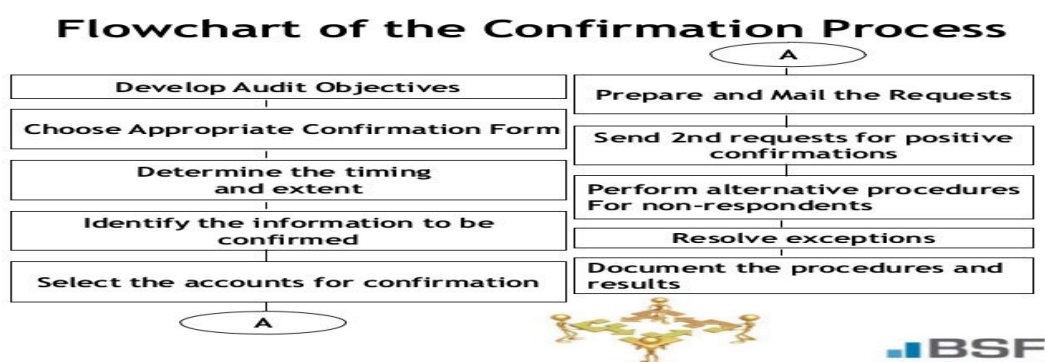


Fig.: Confirmation Process*

* Source : SlideShare

5.2 Advanced Auditing and Professional Ethics

The checking of the debtors' ledger balances does not merely involve a comparison of the balances in the ledger with those shown in the schedule. Each account should be scrutinised in order to do the 'aging' of the debtors. The debtors' schedule should have appropriate columns to indicate the period over which each account is outstanding. The auditors must not assume that any balance which is confirmed is necessarily realisable. Where debts are written off, the auditor should satisfy himself whether the write off was based on appropriate considerations of the relevant facts. Debts often include claims made against insurance companies, shipping companies, railways, etc. and the auditor should ascertain that the claims are realisable. Correspondence should be seen in all major cases in order to ascertain whether the claims have been acknowledged and whether there is a reasonable possibility of their being realised. If it appears that they are not collectible, they should be shown as doubtful. These recommendations can be applied to creditors as well. Based on the above recommendations an outline of a confirmation procedure may be as under:

1. The confirmatory letters should be sent out within a period of 15 to 21 days of the end of the year, even when the audit is taken up much later in respect of balances either as at the date of the Balance Sheet or as at another selected date before the close of the year.
2. If the number of balances is large, letters may be issued only in respect of major debtors and creditors, selected according to some system. Having selected the accounts, the balances wherein are to be confirmed, the client should be requested to prepare statements of account showing the position of the balances as at the date of confirmation. A nil balance account should also be included.
3. The statements of account prepared by the client should be compared by the auditor with the balances of debtors and creditors. Therefore, he should maintain control over them until they are posted.
4. Either each statement of account should contain a request for confirmation of the balance shown therein or it should be forwarded with a separate letter by the auditor or the client, as may have been mutually agreed upon. The letter or the statement should show the address of the auditor to which the statements of account after the confirmation are to be returned. A stamped envelope containing the auditor's name and address should be enclosed.
5. Letters or statements should be posted under the supervision of the auditor.
6. In cases where replies are not received within a reasonable time, a reminder should be sent out by the auditor. Letters received back undelivered should be sent again at the correct address.
7. On receipt of replies from the parties, it should be verified that either the balances have been confirmed or the amounts confirmed can be satisfactorily reconciled with the balances shown by the books of account of the client. The client should be requested to prepare reconciliation statements where necessary.
8. In every case, where a reconciliation statement has been prepared, it should be verified that the difference in the amount confirmed and that shown by the books of account is not the result of an omission to credit any amount received from the party or failure to debit

him with any amount of sales or to credit him with the value of goods received with a view to suppressing or inflating profit.

9. If the difference is the result of some dispute or claim for allowance or return, etc. not afforded to a party, it should be confirmed that there exists a provision equal to the difference which ultimately may have to be credited to him.

Direct confirmation procedure may be performed both for sundry creditors and sundry debtors. Special precautions in respect of creditors to be taken are as under:

- (i) The Creditors' ledger trial balance should be extracted by the client and agreed with the Control Account, if any, before balances are selected for confirmation.
- (ii) The provision made for the amount payable in respect of goods received within the last week of the close of the year should be verified by comparing entries in the Goods Inward Register with the Purchase Journal.
- (iii) A certificate should be obtained from the client that all the liabilities which have accrued up to the date of the Balance Sheet have been taken into account.

Special precautions in respect of sundry debtors to be taken are as under:

- (i) The Debtors' ledger trial balance should be extracted by the client and agreed with the Control Account, if any, before balances are selected for confirmation.
- (ii) The adjustment of sales made at the close of the year should be verified by comparing the entries in the Goods Outward Register for two weeks before the close of the year with these in the Sales Journal.
- (iii) The accounts to be verified by direct confirmation should be settled on the basis of internal control procedures.

5.1.2 Inquiry

SA 500 mentions inquiry as one of the methods of collecting audit evidence by seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may not provide him with corroborative evidence. The need for inquiry may arise at every stage of auditing. Wherever any transaction or entry is not readily understandable or its effects are not readily apparent, the auditor should not hesitate to make enquiry from the appropriate official of the client. Apart from this, students should remember that the auditor of a company has to make a statement in his report on whether he has obtained all the information and explanations that he considered necessary for his audit. This requirement suggests that inquiry is one of the processes of the whole scheme of auditing and, accordingly, the Companies Act, 2013 has given certain powers to the auditor in Section 143(1). Besides, Section 143(1) of the Companies Act, 2013 casts upon the auditor a specific duty to inquire into certain specified transactions. How the auditor is expected to perform the duty of enquiry as contained in Section 143(1) is given in Chapter 8 "Audit Report".

5.4 Advanced Auditing and Professional Ethics

5.1.3 Observation

According to SA 500, Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

5.1.4 Analytical Review Procedures

Analytical review procedures may be defined as substantive tests of financial information made by a study of comparisons and relationship among data.



Fig.: Analytical Review Procedures*

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements,

* Source : *Small Business - Houston Chronicle*

components and individual elements of information.

Essentially these procedures ensure that the various items making up the financial statements are consistent with:

- (a) Each other (for example, the relationship between debtors and sales, or current assets and current liabilities).
- (b) Known trends.
- (c) The auditor's knowledge of the business.

The auditor should ask the following questions:

- (a) What data, ratios and statistics exist which are of significance for the business?
- (b) What should they be compared with (i.e., what yard-stick)?
- (c) Are there any variations between (a) and (b) which the auditors would expect to occur?

The following table summarizes the position:

Types of data, ratios etc.	Comparison with
Financial data (e.g., items in annual statements, management accounts, budgets, etc.)	(i) Corresponding previous period. (ii) Budgets and forecasts (if available).
Non-financial data (e.g., production and employment statistics)	(i) Entries in accounting records. (ii) Other financial data.
Ratios and percentages (developed from financial and non-financial data; for example inventory turnover ratio)	(i) Preceding period. (ii) Budgets and forecasts. (iii) Industry Statistics.

Analytical procedures are used for the following purposes:

- (a) To assist the auditor in planning the nature, timing and extent of other auditing procedures.
- (b) As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.
- (c) As an overall review of the financial information in the final review stage of the audit.

Analytical procedures should be applied to some extent for the purposes referred to in (a) and (c) above for all audits of financial statements. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions.

Analytical procedures in planning the audit – In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

5.6 Advanced Auditing and Professional Ethics

Analytical procedures used as substantive tests – When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330¹, the auditor shall:

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
- (b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

Extent of reliance on analytical procedures – The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity²;

¹ SA 330, paragraph 20.

² SA 500 (Revised), "Audit Evidence", paragraph A31.

- (b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures³.

Analytical Procedures that Assist When Forming an Overall Conclusion – The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly⁴.

The analytical procedures performed in accordance with paragraph 6 of "SA 520 Analytical Procedure" may be similar to those that would be used as risk assessment procedures.

This technique has been discussed at the Intermediate (IPC) level. However, in view of importance of this technique in the context of growing complexities, diversities and volumes of business, it requires a more detailed treatment in the specific area of ratio analysis and related matters. It should be appreciated that an audit programme will be realistic only after the auditor has modified in the light of his experience of the changes and of the state of internal controls operating in the organisation. If the auditor can perceive some of the imperatives under which

³ SA 500 (Revised), paragraph 10.

⁴ SA 315, paragraph 30.

5.8 Advanced Auditing and Professional Ethics

the management operates and the relationship of the business with the economy and environment, he would be able to make the audit programme far more objective. Conflict of interests, inflation, inter-company relations, scarcity conditions, captive market, control by the State, etc. are some of the forces that condition a company's working and management approach to a large extent.

The auditor normally performs an audit by placing reliance on the internal control system. A company's control system may provide for a maximum holding of a particular raw material but if the raw material is a controlled commodity and the supply is irregular, it is obvious that the internal control rule about the maximum or minimum holding of the raw material is of no use to the management which is concerned with the running of the business. As and when the company is allotted a quota or permit for that material irrespective of any consideration, the management will avail of the same. Besides the management will not mind even to procure such material from the open market at a price different from the controlled price, if the materials are needed. For goods to be imported it is often the practice to ask for and obtain an import license for a quantity far larger than is reasonably needed simply to avoid the procedural red tape involved in obtaining a license. Internal control systems, howsoever good, will be of no use in such cases.

It should also be understood that significant non-routine transactions are entered into sometimes in complete disregard of the laid down rules of control. The internal control system may be good as far as the transactions that have been recorded. But if certain transactions are omitted altogether, the internal control system may not be in a position to reveal anything about them. An auditor should always bear in mind these limitations of the control system. These limitations have made it even more important for the auditor to supplement his routine audit programme, by overall tests which are based on judgment of what is reasonable. Ratio analysis is an audit approach that helps the auditor to make an overall assessment of the data by reference to attendant factors.

Relevance of Ratio and Trend Analysis – Ratio analysis is an important supplement to the audit process which has the merit of bringing to focus the abnormalities, deviations and unexpected variations. A ratio measures the relative magnitude of two related factors. It does not have any significance of its own except to provide material for further analysis, interpretation and conclusion. It is a means to objectively assess or diagnose the financial health of a business. The auditor can take a broad view of the data under audit by adopting ratio analysis. He can assess whether the data is reasonable, valid and consistent. Through the process of ratio analysis, any abnormal relationship between two related matters is most likely to be disclosed. It, however, presupposes certain amount of knowledge on the part of the auditor about what should be the reasonable relationship. This may be acquired by the auditor from his knowledge and experience gained elsewhere or from the knowledge of the past relationships. In addition, if there exists certain known relationship, the matter becomes simpler. For example, if the rate of Provident Fund contribution is 10% of the basic pay and dearness allowance, either set of the data can be proved by the other having regard to the given relationship. If the auditor finds the Provident Fund contribution to be of the order of say 6% of the total of basic pay after dearness allowance, this immediately alerts him that some abnormal feature exists, though he should not hasten to the conclusion that it is an error. There may be circumstances, e.g., newly appointed employees are not entitled to the Provident Fund benefit for certain period or there

may be some retired persons re-employed who are not entitled to any provident fund benefit.

Therefore, it may be said that ratio analysis makes it possible for the auditor to locate problem areas which can thereafter be subjected to scrutiny for confirming that the problem really exists or it is manifestation of some real abnormality that business has experienced during the period covered by the audit. This may help also in forestalling an approaching danger before it has done much damage. It is felt that if, at the audit planning stage, the data are subjected to ratio analysis; the auditor would be in a position to plan his audit programme more purposefully. He will be able to devote an appropriate amount of time and effort in areas where abnormalities have been detected. The analysis of ratios and relationships has two phases:

1. The determination and measurement of changes and inter-relationships in data.
2. The scrutiny, explanation and evaluation of the changes and their significance in light of the circumstances.

It has been stated earlier that data must be inter-related for any effective ratio analysis. Apart from this, certain businesses have their own features. A business with high sales volume at a low margin of profit is expected to have a high inventory turnover ratio. If the ratio is low, it will be a pointer for further probe. Similarly, a business offering cash discount for prompt settlement of accounts will have a high debtors' turnover ratio. A business dealing with a widely needed scarce material will in most cases have customer's advances against supply rather than any debtors' balances. On the other hand, in a business where Government is the principal buyer, it is the general nature that the margin of profit is high and the debtors outstanding quite large. For the auditor to properly understand the implications of ratios, such background knowledge is essential.

Also, the auditor is expected to possess the knowledge of normal relationship between related variables in the business he is auditing so that he can discern deviation from the normal and assess significant variation in the relationship. This knowledge can be derived from either a comparison with the concerned business's past corresponding data or by reference to readymade data available about the industry from some official source or by comparing the data with the corresponding data found in another company engaged in the same line of industry in similar circumstances.

The external data are generally considered to be objective and independent in character. These, however, should be used with discretion. The basis and method of compilation, the period covered and the source and author of the data are some of the considerations needed before they are used for comparisons. In India, the Reserve Bank of India Bulletin, the Bombay Stock Exchange Directory, the Calcutta Stock Exchange Directory, Kothari's Economic and Industrial Guide are some of the publications that contain reliable financial information about companies, individually or as a class. However, they should not be considered as a readymade material for comparison because the manner of compilation, the circumstances, etc., may be dissimilar. Subject to review of these data for adjustment these may be used for comparison.

Most of the ratios known to us from our study of Advanced Accounting can be used by the auditor in evaluating different aspects of the financial health of a concern. However, the auditor should be experienced and skillful enough to know what ratio is appropriate for his purpose,

5.10 Advanced Auditing and Professional Ethics

what they would reveal and how to relate matters; also, what can be expected as a result of particular ratio. For example, to know whether the concern's cost of sales bears the normal relation to sales, the auditor may compute gross profit ratio. Now if the gross profit ratio shows any abnormality, depending upon the abnormality, further inference may be drawn for verification and confirmation. If the gross profit ratio is higher than normal, the possibilities that immediately should strike one are: (i) sales overstated, (ii) stock overstated or over valued, (iii) purchases understated, (iv) wages and other costs understated, etc. Now the auditor, having localised the problem areas, can check them extensively to find out whether the doubts are true or certain abnormal situations did prevail that accounts for the distortion. It is also natural for the auditor to expect the ratio of gross profit to net profit to be up in such circumstances unless explained by other abnormal factors working in the opposite direction. For example, the selling and distribution cost or interest on borrowings might have gone up significantly to eat up the excess margin of gross profit. Take another example: suppose the turnover ratio (Sales/Capital) shows a considerable improvement over the last year and there is no concurrent increase in the solvency or liquidity ratios. The auditor should inquire why it is so. It is quite possible that the company has evolved a better system of financial management. It is also possible that (i) sales have been inflated or (ii) the credit policy was defective to result into huge accumulation of debtors or (iii) there had been defalcation of sales proceeds. There are certain quantitative ratios which may be particularly helpful to the auditor, e.g., the ratio between the main raw material consumed to total production may prove both the figures. Auditors can use a number of other quantitative ratios like ratio of man hours to production to verify the accuracy of figures in the Profit and Loss Account and the Balance Sheet. It would thus be seen that by working out ratios, the auditor can identify areas where detailed enquiries are called for. Like a physician, he examines symptoms, analyses them and works out a diagnosis. Such a procedure may prove immensely helpful when used as a supplementing technique to the normal vouch and post audit.

Ratio analysis can be of great use for overall checks. It is to be expected that figures of sales will change together with changes in purchases, wages, expenses, etc. But the mutual relationship of most related figures can change only because of extraordinary circumstances, favourable or adverse. Working out the relationship of ratios, therefore, and comparing them with the previous years, corresponding ratios serve to establish the apparent reasonableness of the figures. To the extent reasonableness is established, the auditor may feel to be on a firm ground when he issues his report. Of course, it should be noted that ratios are one of the ways of application of overall tests.

A good approach is to study the trends. Trend analysis is of course mainly resorted to in investigations. However, it may, be developed as a useful audit tool also to locate areas showing abnormalities. If trends of sales and purchases are studied over a reasonable period say 5 years - any distortion in their relations will be apparent. Similarly, trend of cost of production can be studied along with the trend of the major components of cost. Even the trend of significant ratios can be studied by the auditor over a number of years either by plotting them on a graph paper or by setting them chronologically. The objective of comparison of absolute figures by reference to the corresponding figures of the previous year has been stated by the Government in the context of the requirement in the Pre-Revised Schedule VI to the Companies Act, as follows:

“The intention of displaying the figures relating to the previous year is to facilitate the comparative study of the items in the Balance Sheet and Profit and Loss Account, so that the significance of the figures for the current year can be more readily appreciated and understood”.

Under Schedule III except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

These all highlight one fact: those relevant ratios may be of great value for proper financial analysis and this may bring out the problem areas on which the auditor is directly interested. Students are referred to Study Material in Advanced Accounting.

Investigating Results of Analytical Procedures – If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and
- (b) Performing other audit procedures as necessary in the circumstances.

Further investigation, by means of audit procedures designed to produce a satisfactory conclusion, would be required if management is unable to provide an explanation or if the explanation is not considered adequate.

Analytical procedures used in the overall review – The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity.

The conclusions drawn from the results of analytical procedures designed and performed are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor’s opinion.

The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor’s assessment of the risks of material misstatement and modify the further planned audit procedures accordingly⁵.

The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

5.2 Statistical Sampling in Auditing

The audit evidence should, in total, enable the auditor to form an opinion on the financial information. In forming such an opinion, the auditor does not normally examine all of the information that is

⁵ SA 315, paragraph 30.

5.12 Advanced Auditing and Professional Ethics

available to him because he can reach a conclusion about an account balance, class of transactions or a control by way of judgmental or statistical sampling procedures.



Fig.: Audit Sampling**

Statistical sampling technique is increasingly becoming popular with the auditors. Statistical sampling in auditing stands for the technique of forming an opinion about a group of items on the basis of an examination of a few of the items. It may be recalled that test checking technique is one of the accepted auditing techniques, which most of the professional bodies of the world, including the Institute of Chartered Accountants of India have recommended for use by the members on a proper consideration of facts and applicability. We have also seen the shortcomings of the test check technique as a basis for forming informed opinion about the accounts under audit. Statistical sampling technique may be considered as a refined application of the test check technique which has all the advantages of the latter with the shortcomings removed. The greatest merit of statistical sampling technique lies in its being based on the statistical theory of probability. It is however, not as simplistic as the test checks.

On the basis of the audit carried out, an auditor is required to give a report containing his opinion, about truth and fairness of the accounting statements. In expressing his opinion the auditor never guarantees absolute accuracy of the accounting statements; but he takes a risk of being challenged about the validity of his opinion. Even after a complete checking, he cannot be sure that the accounts and the resulting accounting statements are absolutely free from error, manipulation, fraud or mistake. However, the opinion that he expresses, represents his overall assessment of the truth and fairness of the accounting statement based on his satisfaction that he has applied all professional skill at his command to see that no material error or fraud exists to distort the true and fair view of the accounting statements.

When he checks only a part of the total accounting data in lieu of checking of all the data, it is obvious that the degree of satisfaction obtainable from the latter would not be available; however, a small loss of the degree of satisfaction will be more than compensated by the considerable savings in time and costs for having checked only a fraction of the total data. It is again true that bigger the sample, the greater would be the satisfaction, but from a practical consideration the minimum requisite sample size, if determined statistically will be adequate to express an opinion about the overall truth and fairness of the total data within a reasonable range of precision and with reasonable confidence.

It is important to recognize that certain testing procedures do not come within the definition of

* Source : *Audit Sampling*. McGraw-Hill/Irwin © 2004 The McGraw-Hill Companies.

* Source : TopCAATs

sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise the technique of selecting all items within a population which have a particular significance (e.g., all items over a certain amount) does not qualify as sampling with respect to the portion of the population examined nor with respect to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not be the basis for a valid conclusion about the remaining portion of the population.

5.2.1 Design of the sample and its evaluation

In designing an audit sample, the auditor has to consider the following -

Audit objectives - Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 8 of SA 500 (Revised), when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

Population – The population is the entire set of data from which the auditor wishes to sample in order to reach a conclusion. The auditor determines that the population from which he draws the sample is appropriate for the specific audit objective. For example, if the auditor's objective were to test for overstatement of accounts receivable, his population could be defined as the accounts receivable trial balance. On the other hand, if he was testing for understatement of accounts payable, his population would not be the accounts payable trial balance but could be subsequent disbursements, unfair invoices, unmatched receiving reports or other populations that would provide evidence of understatement of accounts payable. The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. For example, if the auditor's objective is to test the validity of the entity's accounts receivable, he could define the sampling unit for confirmation purposes as either customer balances or individual customer invoices. The auditor should define the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objective. Further regarding population, it should be noted:

- (a) 'Population', or 'field', or 'universe' (i.e. the total number of items potentially subject to scrutiny within a defined area, must be sufficiently large.
- (b) The system which produces the records to be tested must be sufficiently reliable.
- (c) All items within a particular population must be homogeneous, i.e. they must all fall within the same 'category'.

5.14 Advanced Auditing and Professional Ethics

(d) Items within the population must be both (i) identifiable; and (ii) accessible.

Such selection should therefore be entirely random, and for this purpose random number tables are often used. The difficulty often arises, however, that the items within the population are themselves not identifiable in a way which enables such random selection to take place. Petty cash vouchers, for example, are rarely preprinted with a sequential numbering series and randomness will thus have to be ensured in some other way; it will hardly be practical for the auditor himself to set about entering the numbers on the vouchers.

Confidence level – The reliability referred to is usually termed the confidence level. More precisely, in an auditing context, it is the mathematical probability that the mis-statement rate in the sample will not differ from the error rate in the population by more than a stated amount. Confidence level is conveniently expressed as a percentage. Thus, when we speak of a confidence level of 90% we mean that there are 90 chances that the item would fall within the confidence intervals of about 90 to 100, against 10 chances, i.e. the risk we take, that it will not (once again, at a specified level of precision). The confidence level is therefore seen to be complementary to risk.

Precision – The precision may be defined with which we can describe the attributes of a given population. For example, our sample may be chosen such that the mis-statement in the population can be proved to be within 5 percent of the monetary value. But how precise do we require this percentage to be? The bigger our sample, clearly the more precise we can be, but we can never be completely precise for the same reasons as we can never be 100 percent confident. The degree of precision required will depend on the materiality of the items in question. For example, if ₹ 3,000 of mis-statement in a sales ledger population of ₹ 100,000 would be considered to be just not material, then 3 percent would be our precision limits. From this you will deduce that confidence level and precision limits are essentially inter-related, and the two combined would determine the quality of testing. The auditor's assessment of the following factors will primarily be responsible for selecting total limit:

- (i) Evaluation of the functioning of the system of internal control in the area under examination.
- (ii) Materiality of the amounts involved.

Example:

Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice — if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

5.2.2 Defining Mis-statement

The auditor must determine the significance of potential mis-statement as it will determine the way in which tests should be conducted. As per SA 450, a Misstatement is a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

Tolerable mis-statement is the maximum mis-statement in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved his audit objective. Tolerable mis-statement is considered during the planning stage and is related to the auditor's preliminary judgement about materiality. The smaller the tolerable mis-statement, the larger the sample size the auditor will require. Further, we must determine the significance of potential mis-statement, for this will in turn determine the way in which we conduct our tests. For example, in compliance testing any mis-statement will be significant irrespective of its monetary value, because any failure of internal control procedures reduces the reliance that we can place on those procedures. Hence tests of detail will have to be extended. It is not the size of the mis-statement that is significant in these circumstances, but its nature, (indeed there may be no monetarily quantifiable misstatement at all e.g. a payroll may not have been check cast, but it may still be correct). With substantive testing, on the other hand, we are interested in discovering whether there is material misstatement, so in this situation it is purely the amount of the mis-statement that is relevant.

5.2.3 Sample size

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Table 1 and 2 will be similar regardless of whether a statistical or non-statistical approach is chosen.

5.2.4 Sampling risk

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

5.16 Advanced Auditing and Professional Ethics

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

5.2.5 Tolerable misstatement

A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in SA 320 (Revised)⁶, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality. **Tolerable rate of deviation** is a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Statistical sampling procedures – There are many different types of statistical sampling plans, but whatever type is used, procedures for conducting a test will be as follows:

- (a) decide on the relevant confidence level and precision limits;
- (b) calculate the sample size using an appropriate formula or tables designed for the purpose;
- (c) select the sample using random methods;
- (d) carry out the necessary tests;

⁶ Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit", paragraph 9.

- (e) appraise the results.

The most common types of plans adopted by auditors are: Acceptance sampling (with discovery sampling a variation) or Estimation sampling, which may be used to determine:

- (a) population variables, or
- (b) population attributes.

Selection with the aid of the computer – The auditor may use a computer to render considerable assistance in the performance of statistical sampling tests, employing the following methods:

- (a) **Interval sampling** – The computer is programmed to select every n th item stored on magnetic tape, and the items so selected can be copied on to a separate tape and printed out in the form required by the auditor.
- (b) **Random number selection** – The technique of random number selection can be computerised, the random numbers being stored on tape or generated by the computer separately for each application.
- (c) **Random Interval selection** – The dangers of selecting a biased example by the use of a uniform interval can be avoided through the use of random variation of the interval between successive items. Random intervals are selected from random number tables maintained on magnetic tape, or produced by means of a random number generator program.

While applying statistical sampling, it should be remembered that materiality is one of the major considerations to decide whether or not a sample should be selected. For instance in case of certain enterprises like real estate builders, agents, merchant houses, etc. the total number of transactions may be relatively very small and hence are not appropriate for the selection of a sample. Even in case of major enterprises, there are certain items which are so significant that the records relating to them should be scrutinized by the auditor at new item by item basis. For example, the year end closing entries in the journal may be manipulated and, therefore, each entry must be carefully examined and authenticated by the auditor. In actual practice many firms of Chartered Accountants have found limited use of statistical sampling than anticipated by them. The various reasons which may be attributed to this state of affairs are as under:

- (i) Audit has never been a mathematical discipline,
- (ii) Designing and sampling schemes properly take unduly long time.
- (iii) To draw valid conclusions on the basis of statistical sampling, all members of the audit team should have an excellent grasp of the statistical principles involved,

5.2.6 Selection of the sample

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are many methods of selecting samples. The principal methods are as follows:

5.18 Advanced Auditing and Professional Ethics

- (a) Random selection (applied through random number generators, for example, random number tables).
- (b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- (c) Monetary Unit Sampling is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- (e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

5.2.7 Performing Audit Procedures

An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

5.2.8 Nature and Cause of Deviations and Misstatements

In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess

the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

5.2.9 Projecting Misstatements

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. SA 330⁷ provides guidance when deviations from controls upon which the auditor intends to rely are detected.

5.2.10 Evaluating Results of Audit Sampling

The auditor shall evaluate:

- (a) The results of the sample; and
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

⁷ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

5.20 Advanced Auditing and Professional Ethics

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Table 1: Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an

		understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
5. An increase in the number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Table 2: Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely

5.22 Advanced Auditing and Professional Ethics

		more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be

		appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.
7. The number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).

5.3 Risk-Based Audit

Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

The auditor does not normally need to perform specific audit procedures on all areas of audit. He only needs to design audit programmes and procedures on areas earlier identified as major risks that could result in the financial statements being materially misstated. RBA is an essential element of financial audit- both in the attest audit of the financial statements and in the audit of financial systems and transactions including evaluation of internal controls. It focuses primarily on the identification and assessment of the financial statement misstatement risks and provides a framework to reduce the impact to the financial statement of these identified risks to an acceptable level before rendering an opinion on the financial statements. It also provides indicators of risks as a basis of opportunity for improvement of auditee risk management and control processes. This affords an opportunity to the auditee to improve its operations from recommendations on risks that do not have a current impact on the financial statements but impact the audited entity's operational strategies and performance over the longer term.

In the context of performance audit, it is the risk to delivery of an activity or scheme or programme of the entity with economy, efficiency and effectiveness. Awareness of areas that puts the programme or resources at risk from the point of view of economy, efficiency and

5.24 Advanced Auditing and Professional Ethics

effectiveness helps focus audit attention on them. The risk analysis provides a framework for assurance in performance auditing.

5.3.1 Audit risk analysis

The auditor should perform an analysis of the audit risks that impact on the auditee before undertaking specific audit procedures. Risk assessment is a subjective process. It is part of the professional judgment of the auditor and of the particular circumstances. It is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.

Audit risks are brought about by error and fraud:

- ◆ Error is an unintentional mistake resulting from omission, as when legitimate transactions and/or balances are excluded from the financial statements; or by commission, as when erroneous transactions and/or balances are included in the financial statements.
- ◆ Fraud is an intentional misstatement in the accounting records or supporting documents from which the financial statements are prepared. It is intended to deceive financial statement users or to conceal misappropriations.

The auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

An error risk may arise from an error in principle, estimate, critical information processing, financial reporting process or disclosure.

Fraud risk involves manipulation, falsification of accounting records, or misrepresentation in the financial statements of events, transactions or other significant information, or misapplication of accounting principles or misappropriation of funds.

5.3.2 General Steps in the Conduct of RBA

RBA consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:

- ◆ Understand auditee operations to identify and prioritize risks
- ◆ Assess auditee management strategies and controls to determine residual audit risk
- ◆ Manage residual risk to reduce it to acceptable level
- ◆ Inform auditee of audit results through appropriate report

Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited

entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.

Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.

The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.

CASE STUDY

Using Analytical Procedures as Substantive Tests^Ψ

Great Champs, an independent, minor football team, competes in the Southern zone. The team finished in second place in 2006 with a good record. The Great Champs cumulative season attendance of 5,45,459 spectators set a new record high for the team, up from 4,90,000 in 2005. Bank-loan agreements require the Great Champs to submit audited financial statements annually to the bank. M/s. ABC & Co. has been the Great Champs' auditors for the past five years.

One of the major audit areas involved audit of ticket revenues. Those revenues reached nearly ₹ 10,88,0000 in 2005. In the prior years, the audit plan called for detailed testing of revenue accounts to gain assurance that reported ticket revenues were fairly stated.

Mr. Abhi, a new audit manager, just received the assignment to be manager on the 2006 audit. He had worked previously on the Great Champs prior-year audits as a staff auditor. When he learned that he would be managing the current-year engagement, he immediately thought back to all the hours of detailed testing of ticket sales he had performed in earlier years. One some of his other clients Mr. Abhi had been successful at redesigning the audit plans to make better use of analytical procedures as substantive tests. He is beginning to wonder if there was a more efficient way to gather substantive evidence related to ticket revenues on this audit engagement also.

^Ψ Adapted from a case study published in Auditing Cases : Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 133.

5.26 Advanced Auditing and Professional Ethics

In his first meeting with the management of Great Champs for the 2006 audit, Mr. Abhi learned that the Great Champs now use an outside company, M/s. Chicklets, to operate ticket gates for home games. The terms of the contract required M/s. Chicklets to collect ticket stubs so that they could later report total tickets collected per game. Although M/s. Chicklets did not break down the total ticket sales into the various price categories, Mr. Abhi thought there might be a way to develop an analytical procedure using the independently generated total ticket numbers and data from prior audits. To investigate this possibility, he asked a staff person to gather some information related to reported sales. The information that the staff person gathered from the records of the client, M/s. Chicklets and prior-year working papers is as follows:

2006 Park Attendance

Total park attendance	5,45,459
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2006 Number of Games

Weekday games	44
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Weekend games	29
---------------	----

Information from prior-year audit working papers indicate that average per-game attendance for weekend games was 27% higher than average per-game attendance for weekday games.

2006 Per-Game Ticket Prices

Club seats	₹ 300
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Box seats	₹ 200
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General seats : Adult :	₹ 150
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Child :	₹ 75
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Sales Mix	Weekday	Weekend
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Club seats	30%	25%
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Box seats	40%	30%
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General seats Adults	15%	25%
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Child	15%	20%
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Comparison of 2005 ticket prices to 2006 ticket prices reveals an average increase of 12% between the two years.

Information from prior-year audit working papers shows that sales mix has remained fairly constant over the past several years.

2006 Promotion :	Number of Games
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Weekday	7
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Weekend	10
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Information from prior-year audit working papers shows that attendance generally increases by 10 percent when there is a promotion (e.g., free football cap, poster, or special entertainment).

Queries to the Readers

- (i) Using the information provided, what expectation for ticket revenue for the year 2006 fiscal year should be developed by Mr. Abhi?
- (ii) How close would the Great Champs reported ticket revenue have to be to your expectation for you to consider reported ticket revenue reasonable or fairly stated?
- (iii) If reported ticket revenues are outside the “reasonable range” what could explain the difference?
- (iv) If the engagement team decides to use analytical procedures for the Great Champs audit then how will the audit plan differ from prior years?

6

The Company Audit

Companies Act, 2013 is rule based Act. Sections 138 to 148 of the Companies Act, 2013 (hereinafter referred to as the Act unless otherwise mentioned) deal with provisions relating to audit of companies. Therefore, it is quite important to understand these provisions very carefully. You may also study sections 128 to 137 relating to “Accounts” of companies for better understanding of the subject. The provisions relating to ‘audit’ broadly deal with who can be appointed as an auditor under the Act, i.e., qualifications and disqualifications, the manner of appointment and removal of an auditor and rights and duties of an auditor. A scheme of the provisions of the Act relating to audit is given below for quick reference:

SECTIONS DEAL WITH PROVISIONS RELATING TO AUDIT OF COMPANIES

- | | |
|------|---|
| 138. | Internal Audit. |
| 139. | Appointment of auditors. |
| 140. | Removal, resignation of auditor and giving of special notice. |
| 141. | Eligibility, qualifications and disqualifications of auditors. |
| 142. | Remuneration of auditors. |
| 143. | Powers and duties of auditors and auditing standards. |
| 144. | Auditor not to render certain services. |
| 145. | Auditors to sign audit reports, etc. |
| 146. | Auditors to attend general meeting. |
| 147. | Punishment for contravention. |
| 148. | Central Government to specify audit of items of cost in respect of certain companies. |

6.1 Eligibility, Qualifications and Disqualifications of an Auditor

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by section 141 of the Companies Act, 2013 (hereinafter referred as the Act). The main provisions are stated below:

(1) A person shall be **eligible for appointment** as an auditor of a company **only if he is a chartered accountant**:

It may be noted that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

(2) Where a firm including a limited liability partnership is appointed as an auditor of a

company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

(3) Under sub-section (3) of section 141 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely:-

- (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;
- (b) an officer or employee of the company;

According to Section 2(59) of the Companies Act, 2013, the term 'Officer' includes :

- (i) Director
- (ii) Manager
- (iii) Key Managerial personnel
- (iv) Shadow Directors.

Example 1: G, a CA in practice is director in RST Ltd. On combined reading of Section 141(3)(b) and Section 2(59), it may be concluded that CA. G would be disqualified to be appointed as an auditor of RST Ltd.

Example 2: G, a CA in practice is director in Zed Ltd., holding company of RST Ltd. On combined reading of Section 141(3)(b) and Section 2(59), it may be concluded that CA. G would be disqualified to be appointed as an auditor of Zed Ltd. but would not be disqualified in case of RST Ltd.

- (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

This sub-section disqualifies the below mentioned persons from being appointed as auditor of a company :

- (i) partner of an officer of the company;
- (ii) employee of an officer of the company;
- (iii) partner of an employee of the company;
- (iv) employee of an employee of the company.

- (d) a person who, or his relative or partner -

- (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

It may be noted that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

6.3 Advanced Auditing and Professional Ethics

It may also be noted that the condition of rupees one lakh shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities:

Students may also note that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor **within 60** days of such acquisition or interest.

The following points may be noted in this regard

- (i) ***The value of shares of ₹ 1,00,000 that can be held by relative is the face value not the market value.***
- (ii) The limit of ₹ 1,00,000 would be applicable where the securities are held by the relative of an auditor and not where the securities are held by an auditor himself or his partner. In case of an auditor or his partner, securities of even small value shall be a disqualification.
- (iii) Grace period of 60 days for corrective action shall apply only in respect of securities held by relatives. This would not apply to auditor or his partner.
- (iv) Limit of ₹ 1,00,000 and grace period of 60 days would be applicable where securities are held in the company only.

Section 2(77) of the Companies Act, 2013 defines the term “relative” to mean anyone who is related to another as:

- (i) members of a Hindu Undivided Family;
- (ii) husband and wife; or
- (iii) one person is related to the other in such manner as may be prescribed.

Rule 4 of the Companies (Specification of Definitions Details) Rules, 2014 prescribes the list of relatives as per Section 2(77). As per the said rule, a person shall be deemed to be relative of another if he or she is related to another in the below mentioned manner;

Father (including step- father), Mother (including step-mother), Son (including step-son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step- sister).

Examples

Ex 1: “Mr. A”, a practicing Chartered Accountant, is holding securities of “XYZ Ltd.” having face value of ₹ 900/-. Whether Mr. A is qualified for appointment as an Auditor of “XYZ Ltd.”?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

In the present case, Mr. A. is holding security of ₹ 900 in the XYZ Ltd, therefore he is not eligible for appointment as an auditor of "XYZ Ltd".

Ex 2: "Mr. P" is a practicing Chartered Accountant and "Mr. Q", the relative of "Mr. P", is holding securities of "ABC Ltd." having face value of ₹ 90,000/-. Whether "Mr. P" is Qualified from being appointed as an auditor of "ABC Ltd."?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company: Further as per proviso to this Section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the present case, Mr. Q. (relative of Mr. P), is having securities of ₹ 90,000 face Value in ABC Ltd., which is as per requirement of proviso to section 141(3)(d)(i). Therefore, Mr. P will not be disqualified to be appointed as an auditor of ABC Ltd.

Ex 3: "M/s BC & Co." is an Audit Firm having partners "Mr. B" and "Mr. C", and "Mr. A" the relative of "Mr. C", is holding securities of "MWF Ltd." having face value of ₹ 1,01,000/-. Whether "M/s BC & Co." is qualified from being appointed as an auditor of "MWF Ltd."?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company: Further as per proviso to this Section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s BC & Co, will be disqualified for appointment as an auditor of MWF Ltd as the relative of Mr. C (i.e. partner of M/s BC & Co.), is holding the securities in MWF Ltd which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Ex 4: *M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of ₹10 each) in Enn Ltd. having market value of ₹ 1,50,000. Whether M/s RM & Co. is disqualified to be appointed as auditors of Enn Ltd.?*

As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or

6.5 Advanced Auditing and Professional Ethics

a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹1,00,000.

In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA. M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹50,000 only (5,000 shares x ₹10 per share).

Therefore, M/s RM & Co. is not disqualified for appointment as an auditors of Enn Ltd. as the relative of CA. R (i.e. partner of M/s RM & Co.) is holding the securities in Enn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

- (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh; or
- (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of one lakh rupees.

Disqualification due to indebtedness.

1. Direct Indebtedness

A person shall be disqualified to be appointed as auditor if he or his relative or his partner is indebted in excess of ₹ 5 Lakhs to -

- (i) the company; or
- (ii) its subsidiary; or
- (iii) its holding company; or
- (iv) its associate company; or
- (v) a subsidiary of such holding company.

2. Indirect Indebtedness

A person shall be disqualified to be appointed as auditor if he or his relative or his partner has given a guarantee or provided any security in connection with the indebtedness of any third person in excess of ₹ 1 lakh to -

- (i) the company; or
- (ii) its subsidiary; or
- (iii) its holding company; or
- (iv) its associate company; or
- (v) a subsidiary of such holding company.

- (e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

Students may note that for the purpose of clause (e) above, the term “business relationship” shall be construed as any transaction entered into for a commercial purpose, except -

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
 - (ii) commercial transactions which are in the ordinary course of business of the company at arm’s length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.
- (f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel;
- (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ` 100 crore;
- (h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;
- (i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services;
- (v) investment advisory services;
- (vi) investment banking services;

6.7 Advanced Auditing and Professional Ethics

- (vii) rendering of outsourced financial services;
- (viii) management services; and
- (ix) any other kind of services as may be prescribed.

It may be noted that an auditor or audit firm who or which has been performing any non audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Further, in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual, shall be termed as rendering of services directly or indirectly by the auditor; and in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, shall be termed as rendering of services directly or indirectly by the auditor.

Example: CA. Poshin is providing the services of investment banking to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which includes investment banking services.

Therefore, CA. Poshin is advised not to accept the assignment of auditing as the service he rendering is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

- (4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

CASE STUDY

Mr. A, a chartered accountant has been appointed as an auditor of Laxman Ltd. In the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

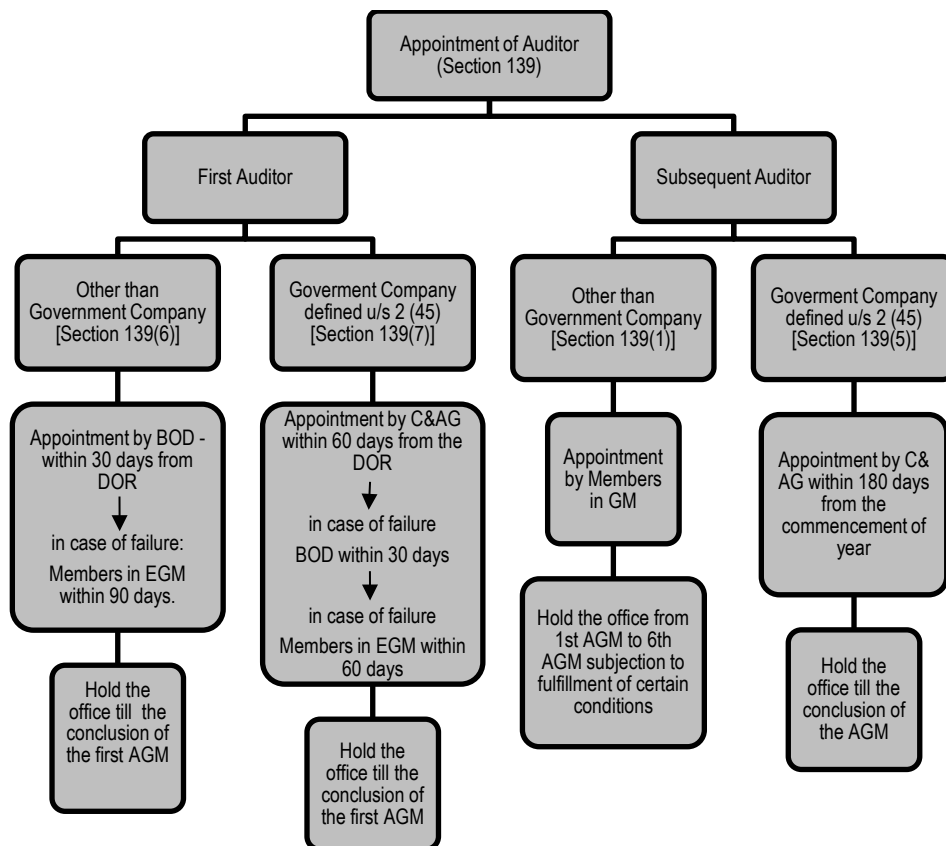
Provisions and Explanation: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited.

6.2 Appointment of Auditor

Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-

- I Appointment of First Auditors.
- II Appointment of Subsequent Auditors



6.9 Advanced Auditing and Professional Ethics

6.2.1 Appointment of First Auditor

6.2.1.1 Appointment of First Auditors in the case of a company, other than a Government Company: As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

CASE STUDY

Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company”. In the instant case, the proposed appointment of Shri Ganpati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

Conclusion: In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

6.2.1.2 Appointment of First Auditors in the case of Government Company: A “Government company” is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

CASE STUDY

The first auditor of Healthy Wealthy Ltd., a Government company, was appointed by the Board of Directors.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 (the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company”. Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence in the case of Healthy Wealthy Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditors made by the Board of Directors of Healthy Wealthy Ltd. is null and void.

6.2.2 Appointment of Subsequent Auditor/Re-appointment of Auditor**6.2.2.1 Appointment of subsequent auditors in case of Non Government Companies:**

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

- (i) The company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.
- (ii) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (iii) The certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.
- (iv) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

6.2.2.2 Appointment of subsequent auditors in case of Government Companies: As per Section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year,

6.11 Advanced Auditing and Professional Ethics

appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

6.2.3 Filling of a Casual Vacancy

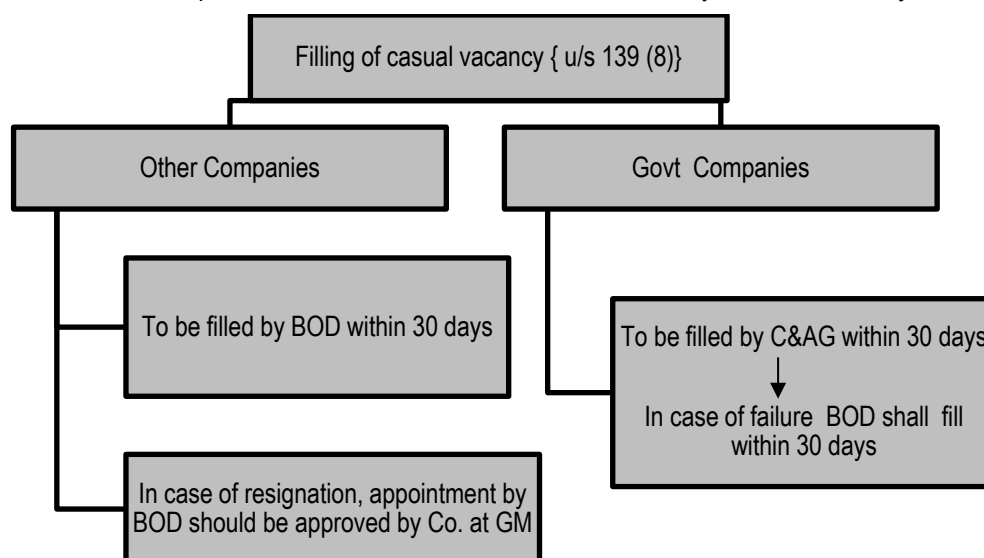
As per Section 139(8), any casual vacancy in the office of an auditor shall -

- (i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

- (ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



6.2.3.1 Casual Vacancy by Resignation: As per section 140(2), the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form ADT-3** (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India,

indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140(3).

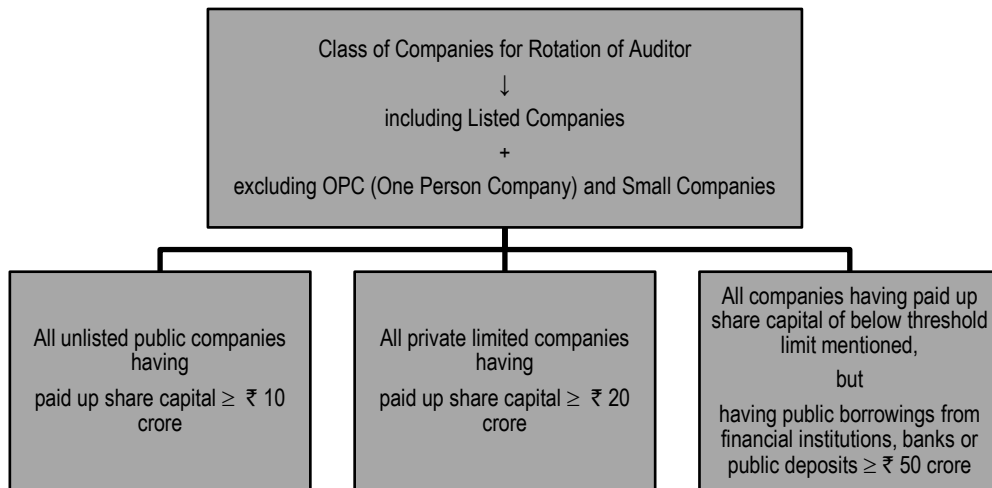
Other Important Provisions Regarding Appointment of Auditors

1. A retiring auditor may be re-appointed at an annual general meeting, if-
 - (a) he is not disqualified for re-appointment;
 - (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
 - (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
2. Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

6.3 Rotation of Auditor

6.3.1 Applicability of section 139(2) Rotation of Auditor

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the **class of companies** shall mean the following classes of companies:-



- (a) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (b) all private limited companies having paid up share capital of rupees twenty crore or more;
- (c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

6.13 Advanced Auditing and Professional Ethics

Example: Rano Ltd. is a private limited Company, having paid up share capital of rupees 18 crore but having public borrowing from nationalized banks and financial institutions of rupees 72 crore, manner of rotation of auditor will be applicable.

As per Section 139(2), no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

- (a) an individual as auditor for more than one term of five consecutive years; and
- (b) an audit firm as auditor for more than two terms of five consecutive years. Provided that -
 - (i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;
 - (ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

Example: *Jolly Ltd., a listed company, appointed M/s Polly & Co., a Chartered Accountant firm, as the statutory auditor in its AGM held at the end of September, 2016 for 11 years. Here, the appointment of M/s Polly & Co. is not valid as the appointment can be made only for one term of five consecutive years and then another one more term of five consecutive years. It can't be appointed for two terms in one AGM only. Further, a cooling period of five years from the completion of term is required i.e. the firm can't be re-appointed for further 5 years after completion of two terms of five consecutive years.*

The following points merit consideration in this regard-

1. As on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

Example: M/s XYZ & Co., is an audit firm having partner Mrs. X, Mr. Y and Mr. Z, whose tenure has expired in the company immediately preceding the financial year, M/s ABZ & Co., is another audit firm in which Mr. Z is a common partner, will also be disqualified for the same company along with M/S XYZ & Co. for the period of five years.

2. Every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section ***within a period which shall not be later than the date of the first annual general meeting of the company held, within the period specified under sub-section (1) of section 96, after three years from the date of commencement of this Act.***

Example 1: Mr. Raj, a Chartered Accountant, is an individual auditor of Binaca Limited for last 5 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013), here a break in the term for a continuous period of five years will not be considered as fulfilling the requirement of rotation. Thus, Mr. Raj can continue the audit of Binaca Ltd. upto

the first annual general meeting to be held after three years from the date of commencement of the Act due to transitional effect.

Example 2: M/s Raj Associates, a Chartered Accountants Audit Firm, is doing audit of Binaca Limited for last 11 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013), here a break in the term for a continuous period of two terms of five consecutive years will not be considered as fulfilling the requirement of rotation. Thus, M/s Raj Associates can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act due to transitional effect.

Students may interlink the above example with Illustrative table explaining rotation in case of individual auditor as well as audit firm which has been given after the 6.3.2 i.e. Manner of rotation of Auditors by the Companies on Expiry of their Term.*

The ICAI made a clarification dated 30.09.2016 on the difference in requirements relating to auditor's rotation under SQC 1 vis-à-vis Companies Act, 2013.

In case of audits of listed entities, SQC 1 requires rotation of engagement partner after a pre-defined period normally not more than seven years. Now, since SQC 1 is applicable from April 1, 2009, the provisions regarding the rotation of engagement partner would be due from April 1, 2016 as per the SQC 1 during the transition phase.

Further, the Companies Act, 2013 is also applicable from April 1, 2014 and the existing companies which is required to comply with provisions of this sub-section, shall comply with the requirements of this auditor's rotation provisions within 3 years from the date of commencement of this Act. Therefore, the provisions regarding auditor's rotation would be due from April 1, 2017 as per the Companies Act, 2013 during the transition phase

Hence, there is a difference of 1 year in the compliance of auditor's rotation provision between SQC 1 vis-à-vis the Companies Act, 2013 during the transition phase of implementation of the Companies Act, 2013.

Thus, the Council of the ICAI decided to provide relaxation in the requirement of rotation of engagement partner given in SQC 1 for the transition phase (i.e. for the financial year 2016-17).

3. It has also been provided that right of the company to remove an auditor or the right of the auditor to resign from such office of the company shall not be prejudiced.
4. Subject to the provisions of this Act, members of a company may resolve to provide that-
 - (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
 - (b) the audit shall be conducted by more than one auditor.
5. The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors.

6.15 Advanced Auditing and Professional Ethics

6.3.2 Manner of Rotation of Auditors by the Companies on Expiry of their Term

Rule 6 of the Companies (Audit and Auditors) Rules, 2014 prescribes the manner of rotation of auditors on expiry of their term which is given below:

- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- (3) For the purpose of the rotation of auditors-
 - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be.
 - (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

Explanation I - For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Explanation II - For the purpose of rotation of auditors,-

- (a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;
- (b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

*Illustration explaining rotation in case of individual auditor

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II
I	II	III
5 Years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years

3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

Note:

1. Individual auditor shall include other individuals or firms whose name or trade mark or brand is used by such individual, if any.
2. Consecutive years shall mean all the preceding financial years for which the individual auditor has been the auditor until there has been a break by five years or more.

***Illustration explaining rotation in case of audit firm**

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 Years (or more than 10years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 year	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 year	7 years	10 years
2 years	8 years	10 years
1 years	9 years	10 years

Note:

1. Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
 2. Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

6.4 Provisions relating to Audit Committee

6.4.1 Applicability of section 177 i.e. Constitution of Audit Committee

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

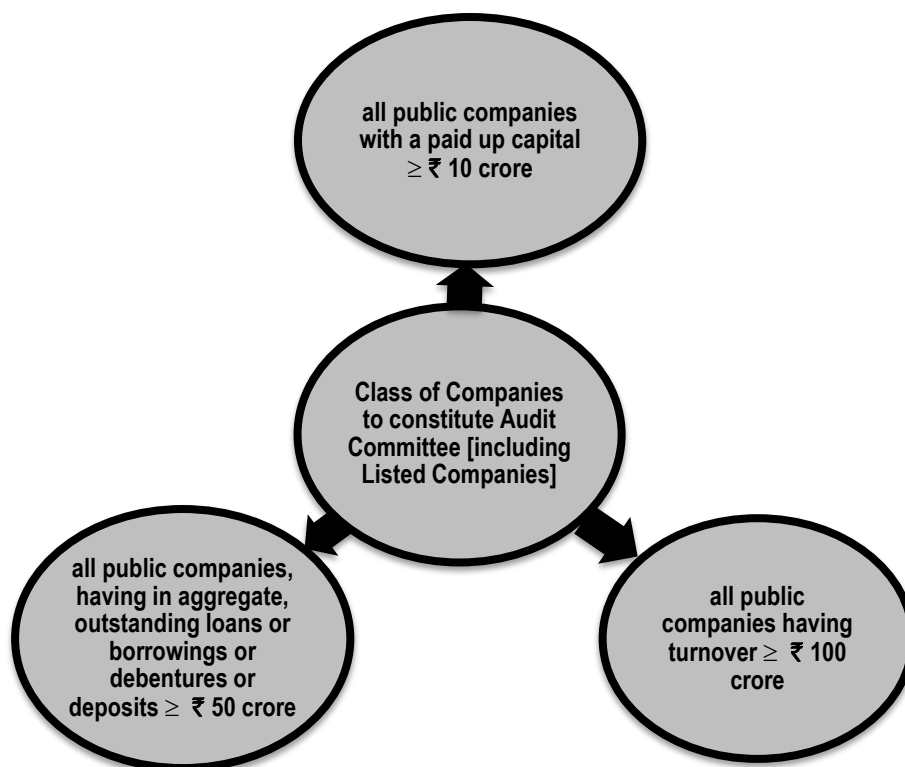


Diagram showing class of companies to constitute Audit Committee

It is important to know that in addition to listed companies, following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Example: XYZ Ltd., a public company having paid up capital of ₹ 9 crore but having turnover of ₹ 150 crore, will be required to constitute an Audit Committee under section 177 because the requirement for constitution of Audit Committee arises if the company falls into any of the prescribed condition.

6.4.2 Manner and procedure of selection and appointment of auditors

Rule 3 of CAAR 2014 prescribes the following manner and procedure of selection and appointment of auditors.

(1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

(2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.

(3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

(4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

(5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

(6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

(7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

It may be noted that such appointment shall be subject to ratification in every annual general meeting till the sixth such meeting by way of passing of an ordinary resolution.

6.19 Advanced Auditing and Professional Ethics

Explanation.- For the purposes of this rule, it is hereby clarified that, if the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.

6.5 Auditor's Remuneration

As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

Further, the remuneration, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.

6.6 Removal of Auditors

6.6.1 Removal of Auditor before Expiry of Term

According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014:

- (1) The application to the Central Government for removal of auditor shall be made in **Form ADT-2** and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- (2) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- (3) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Direction by Tribunal in case auditor acted in a fraudulent manner: As per sub-section (5) of the section 140, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

6.6.2 Appointment of Auditor other than retiring Auditor

Section 140 lays down procedure to appoint an auditor other than retiring auditor who was removed:

1. Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under sub-section (2) of section 139.
2. On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
3. Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-
 - (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
 - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting -

Students may note that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by this sub-section are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

6.7 Ceiling on Number of Audits

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section

6.21 Advanced Auditing and Professional Ethics

141(3)(g) of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ` 100 crore, shall not be eligible for appointment as an Auditor of a Company.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

CASE STUDY

"ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.

- (i) Provide the maximum number of Audits remaining in the name of "ABC & Co."
- (ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.
- (iii) Can ABC & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ` 100 crore, 2 small companies and 1 dormant company?
- (iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?

Fact of the Case: In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ` 100 crore.

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

- (i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm	= 20*3	= 60
Number of Audits already taken by all the partners		
In their individual capacity	= 4+6+10	= 20
Remaining number of Audits available to the Firm		= 40
- (ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) Mr. A can hold: 20 - 4 = 16 more audits. (2) Mr. B can hold 20-6 = 14 more audits and (3) Mr. C can hold 20-10 = 10 more audits.
- (iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.
- (iv) As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores. In the given case, out of the 60 private companies ABC & Co. is offered, 45 companies having paid-up share capital of ₹ 110 crore each.

Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

Council General Guidelines, 2008 (Chapter VIII): In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the “specified number of audit assignments of the companies under Section 224 and / or Section 226 of the Companies Act, 1956 (Section 141(3)(g) of the Companies Act, 2013).

It may be noted that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

It may also be noted that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not

6.23 Advanced Auditing and Professional Ethics

exceed the specified number of audit assignments in the aggregate.

it is further provided that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in relation to such chartered accountant and by him shall not exceed the specified number of audit assignments in the aggregate.

1. In computing the specified number of audit assignments.
 - (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.
 - (b) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.
 - (c) a chartered accountant in full time employment elsewhere shall not be taken into account.
2. A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

Ceiling on Tax Audit Assignments: The specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is 60 numbers. The ceiling limit was **increased from 45 to 60 numbers in the year 2014**. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.

6.8 Powers/Rights of Auditors

The auditor has following powers/rights while conducting an audit:

- (a) **Right of access to books, etc.**– Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

It may be noted that according to section 2(59) of the Act, the term 'officer' includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act.

The phrase 'books, accounts and vouchers' includes all books which have any bearing, or are likely to have any bearing on the accounts, whether these be the usual financial books or the statutory or statistical books; memoranda books, e.g., inventory books, costing records and the

like may also be inspected by the auditor. Similarly the term 'voucher' includes all or any of the correspondence which may in any way serve to vouch for the accuracy of the accounts. Thus, the right of access is not restricted to books of account alone and it is for the auditor to determine what record or document is necessary for the purpose of the audit.

The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per section 143(8).

Further, the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

Case Study

While conducting the audit of a limited company for the year ended 31st March, 2016, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

Provisions and Explanation: Section 143 of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

Conclusion: In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

(b) **Right to obtain information and explanation from officers-** This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him. When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

(c) **Right to receive notices and to attend general meeting-** The auditors of a company are entitled to attend any general meeting of the company (the right is not restricted to those at

6.25 Advanced Auditing and Professional Ethics

which the accounts audited by them are to be discussed); also to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Section 146 of the Companies Act, 2013 discusses right as well as duty of the auditor. According to the section 146:

“all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.”

Thus, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

(d) Right to report to the members of the company on the accounts examined by him- The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

(e) Right to Lien- In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents. The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.
- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under section 128 of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Audit Documentation (explanatory text, A- 25), "Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel."

6.8.1 Powers / Rights of Comptroller and Auditor-General of India

Section 143(5) of the Act states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor (discuss in the beginning of the chapter) and direct such auditor the manner in which the accounts of the company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to,

- (a) **conduct a supplementary audit under section 143(6)(a)**, of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
- (b) **comment upon or supplement such audit report under section 143(6)(b).**

It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures

6.27 Advanced Auditing and Professional Ethics

issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit under section 143(6)(b): Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

6.9 Duties of Auditors

Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

1. Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider

his duties under section 143(1).”

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

2. Duty to Sign the Audit Report: As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of sub-section (2) of section 141 and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditors' report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

3. Duty to comply with Auditing Standards: As per sub-section (9) of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further as per sub-section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. Students may note that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

4. Duty to audit report: As per sub-section (3) of section 143, the auditor's report shall also state –

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section

6.29 Advanced Auditing and Professional Ethics

- (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
 - (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
 - (j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-
 - (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
 - (iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

[Notes: (1) Students may note that the auditor is also required to report on certain additional matters specified under Companies (Auditor's Report) Order, 2016 which is discussed in Chapter 8 on Audit Report.

(2) Students are also required to refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013.]

5. Duty to report on frauds:

A. Reporting to the Central Government- As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the Rule 13 states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (a) **the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;**

- (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
- (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
- (e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- (f) the report shall be in the form of a statement as specified in Form ADT-4.

B. Reporting to the Audit Committee or Board- Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

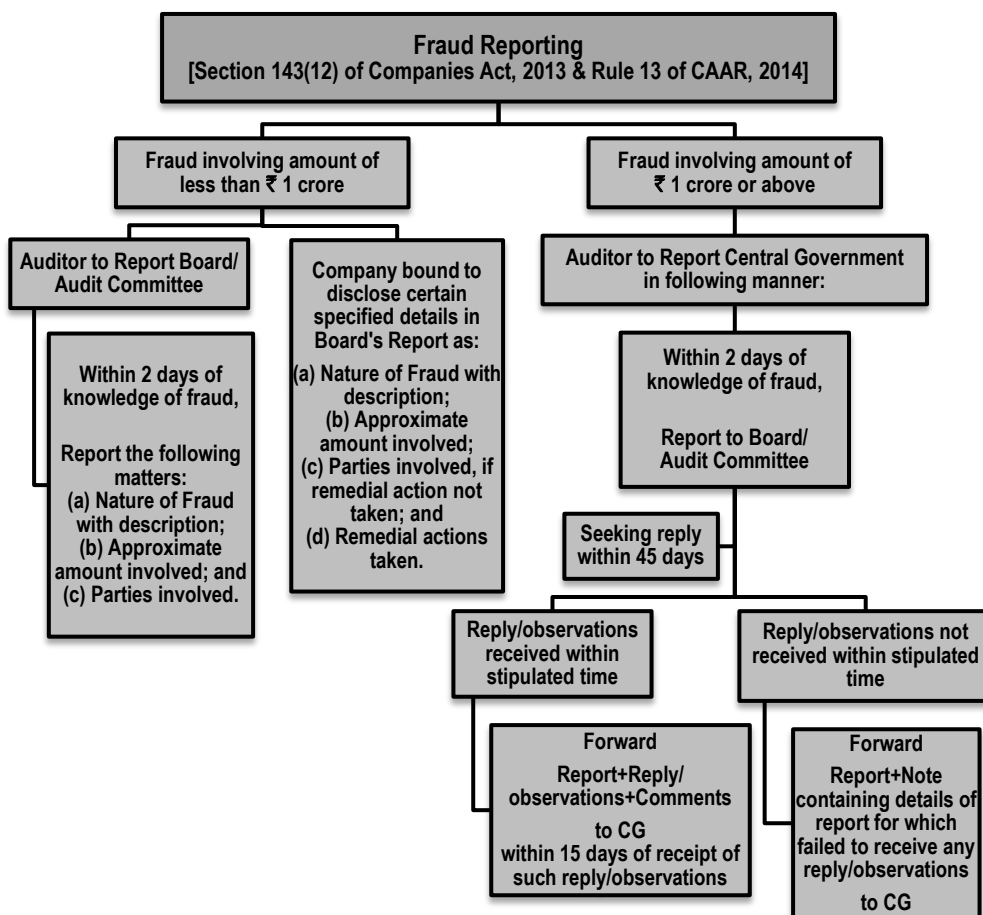
- (a) Nature of Fraud with description;
- (b) Approximate amount involved; and
- (c) Parties involved.

C. Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the company is required to disclose in the Board's Report the

following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

- (a) Nature of Fraud with description;
- (b) Approximate Amount involved;
- (c) Parties involved, if remedial action not taken; and
- (d) Remedial actions taken.



Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provisions regarding fraud reporting shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees).

The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 [CARO, 2016], whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The Auditing and Assurance Standards Board of the ICAI has issued the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 to provide guidance to the members on this new reporting requirement.

The definition of fraud as per SA 240 and the explanation of fraud as per Section 447 of the 2013 Act are similar, except that under section 447, fraud includes 'acts with an intent to injure the interests of the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.' However, an auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account/financial statements of the company. For example,

(i) an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;

(ii) if the password of a key managerial personnel is stolen and misused to access confidential/restricted information, the effect of the same may not be determinable by the management or by the auditor;

Therefore, the auditor shall consider the requirements of the SAs, insofar as it relates to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.

[Note: Students are required to refer Guidance note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 for detailed knowledge.]

Example: The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report.

It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹1 crore, however, reporting under CARO, 2016 is required.

6.33 Advanced Auditing and Professional Ethics

6. Duty to report on any other matter specified by Central Government: The Central Government may, in consultation with the National Financial Reporting Authority (NFRA), by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

However, as per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may hold consultation required under this sub-section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the MCA and the Committee shall have the representatives from the ICAI and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards (NACAS) and the office of the C&AG.

7. Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately in the chapter under heading 6.13 branch audit.

8. Duty to state the reason for qualification or negative report: As per sub-section (4) of section 143, where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.

6.9.1 Other Duties under Companies Act, 2013

The following are the other duties of an auditor under Companies Act 2013 -

(i) **Register of charges** - Every company under Section 85 is required to keep a Register of charges at its registered office to enter therein particulars of all the charges registered with the Registrar on any of the property, assets or undertaking of the company and the particulars of any property acquired subject to a charge as well as particulars of any modification of a charge and satisfaction of charge. The entries in the register of charges maintained by the company shall be made forthwith after the creation, modification or satisfaction of charge, as the case may be. Entries in the register shall be authenticated by a director or the secretary of the company or any other person authorised by the Board for the purpose. The register of charges shall be preserved permanently and the instrument creating a charge or modification thereon shall be preserved for a period of eight years from the date of satisfaction of charge by the company. The register kept under this section shall be kept open for inspection during business hours. This register should be examined by the auditor to ascertain whether any of the assets belonging to the company except bearer securities, is subject to charge, and, if so, its nature.

Where the instrument creating or modifying a charge is not filed within a period of 300 days from the date of its creation (including acquisition of a property subject to a charge) or modification and where the satisfaction of the charge is not filed within 30 days from the date on which such payment of satisfaction, the Registrar shall not register the same unless the delay is condoned by the Central Government. The application for condonation of delay shall be filed with the Central Government in relevant Form along with the fee.

(ii) Register of contracts with companies and firms in which the directors are interested - This Register is maintained pursuant to sub-section (1) of Section 189. It contains a record of particulars of all contracts or arrangements that attract the provisions of Sections 184 and 188.

Every Director or key managerial personnel shall within a period of 30 days of his appointment, or relinquishment of his office, as the case may be disclose to the company the particulars related to his concern or interest in the associations which are required to be included in the register. The particulars of the company or companies or bodies corporate in which a director himself together with any other director holds not more than 2 percent of the paid-up share capital would not be required to be entered in the register.

The register shall be kept at the registered office of the company and the register shall be preserved permanently and shall be kept in the custody of the company secretary of the company or any other person authorised by the Board for the purpose.

The company shall provide extracts from such register to a member of the company on his request, within 7 days from the date on which such request is made upon the payment of such fee as may be specified in the articles of the company but not exceeding ten rupees per page.

The provisions of Section 189 are not applicable to; (a) contracts or arrangements for the sale or purchase or supply of goods, materials or services, if the value or cost thereof in any year does not exceed ₹ 5,00,000 in aggregate; and (b) contracts or arrangements by banking companies for the collection of bills in the ordinary course of business.

It is the duty of the auditor to examine the Register to find out whether transactions of purchase or sale of goods in which a director or directors were interested were entered into under the sanction of the Board and the directors concerned had disclosed their interest.

(iii) Register of investment or loan made, guarantee given or security provided in relation to any body corporate - In pursuance of sub-section (9) of Section 186, every company giving loan or giving guarantee or providing security or making an acquisition of securities shall, from the date of its incorporation, maintain a register in **Form MBP 2** and enter therein separately, the particulars of loans and guarantees given, securities provided and acquisitions made as aforesaid.

The register shall be kept at the registered office of the company and the register shall be preserved permanently and shall be kept in the custody of the company secretary of the company or any other person authorised by the Board for the purpose.

The entries in the register shall be made chronologically in respect of each such transaction within 7 days of making such loan or giving guarantee or providing security or making acquisition.

The extracts from the register maintained may be furnished to any member of the company on payment of such fee as may be prescribed in the Articles of the company which shall not exceed ten rupees for each page.

(iv) Register of investments held in the names of Nominees - Normally, a company is expected to hold investments in its own name [Section 187]. But where in pursuance of Section-

6.35 Advanced Auditing and Professional Ethics

187(2)(d), any shares or securities in which investments have been made by a company are not held by it in its own name, the company shall maintain a register which shall contain particulars of investments in shares or other securities beneficially held by the company but which are not held in its own name and the company shall also record the reasons for not holding the investments in its own name and the relationship or contract under which the investment is held in the name of any other person. The company is also required to record whether such investments are held in a third party's name for the time being or otherwise. The register shall be maintained at the registered office of the company. It shall be preserved permanently and shall be kept in the custody of the company secretary of the company or if there is no company secretary, any director or any other officer authorised by the Board for the purpose.

The auditor should examine the register during the course of inspection of securities.

(v) Register of directors and key managerial personnel and their shareholding - Under the provisions of Section 170(1) of the Companies Act, 2013, it is obligatory for a company to maintain a record, in a register containing particulars of the directors and key managerial personnel which shall include the details of securities held by each of them in the company or its holding, subsidiary, subsidiary of company's holding company or associate companies.

Under Sub-section (2) of the aforesaid section, a return containing the particulars of appointment of director or key managerial personnel and changes therein, shall be filed with the Registrar in **Form DIR-12** along with such fee as may be provided in the Companies (Registration Offices and Fees) Rules, 2014 within 30 days of such appointment or change, as the case may be.

The auditor should refer to this register to find out the names of persons who had held different offices during the year under audit to confirm that various transactions entered into by the company have been authorised by a competent person.

(vi) Managerial Remuneration - Disclosure in the accounts is made.

A note showing the computation of net profits in accordance with Section 198 of the Act with relevant details of calculation of the commission payable by way of such profits the directors (including managing directors or managers) should be given.

Personal expenses of Directors - All payments to directors by way of remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the provisions of the Companies Act and Articles of Association of the company. In some cases, depending upon the provisions contained in the Articles, the remuneration may require sanction of the shareholders either by an ordinary or special resolution while, in other cases, it may require only approval of the Directors. If the terms of appointment of a director include payment of expenses of personal nature then such expenses can be incurred by the company. Where, however, the contract with the director or the conditions of employment does not contain any provision for payment of expenses of a personal nature, then there is no warrant for incurring or reimbursement of such expenses by the company and if such expenses are paid the auditor should disclose the fact in his report, as also in the accounts. Attention in this regard is invited to Section 143(1)(e) of the Companies Act.

(vii) Loan and investment by company (Section 186) –

(1) Section 186(1) of the Act states that a company shall make investment through not more than two layers of investment companies.

'Layer' in relation to a holding company means its subsidiary or subsidiaries [Explanation (d) of Section 2(87) of the Companies Act, 2013].

(2) No company shall directly or indirectly:

- (a) give any loan to any person or any other body corporate;
- (b) give any guarantee, or provide security in connection with a loan to any other person or body corporate; and
- (c) acquire by way of subscription, purchase or otherwise, the securities of any other body corporate,

exceeding 60 per cent of its paid-up share capital, free reserves and securities premium account or one hundred per cent of its free reserves and securities premium account, whichever is more.

It may be noted that where the giving of any loan or guarantee or providing any security or the acquisition exceeds the limits specified in that sub-section, prior approval shall be necessary by means of a special resolution passed at a general meeting.

The company is required to disclose to the members in the financial statement the full particulars of the loan given, investment made or guarantee given or security provided and the purpose for which the same mentioned above proposed to be utilized by the recipient of the loan or guarantee or security.

(3) The company cannot make investment, or give loan or guarantee or security unless the resolution sanctioning it is passed at the Board meeting with the consent of all the Directors present at the meeting and the prior approval of the public financial institution (PFI) concerned where any term loan is subsisting is obtained. It is provided that the prior approval of PFI shall not be required where the aggregate of the loans and investments so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate, along with the investments, loans, guarantee or security proposed to be made or given does not exceed the limit as specified in sub-section (2), and there is no default in repayment of loan instalments or payment of interest thereon as per the terms and conditions of such loan to the PFI.

As per the Companies Act, 'Public Financial Institution' means:

- (i) the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956;
- (ii) the Infrastructure Development Finance Company Limited, referred to in clause (vi) of sub-section (1) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;
- (iii) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002;
- (iv) institutions notified by the Central Government under sub-section (2) of section 4A of the

6.37 Advanced Auditing and Professional Ethics

Companies Act, 1956 so repealed under section 465 of this Act;

- (v) such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India:

Students may note that no institution shall be so notified unless—

- (A) it has been established or constituted by or under any Central or State Act; or
(B) not less than fifty-one percent of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments.

(4) The Companies which are registered under section 12 of the Securities and Exchange Board of India act, 1992 and covered under such class or classes of companies as may be prescribed shall not take inter-corporate loan or deposits exceeding prescribed limit and such company shall furnish in its financial statement the details of the loan or deposits.

(5) No loan under this section shall be given at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan.

(6) No company, which has defaulted in repayment of any deposits accepted before or after the commencement of this Act or in payment of interest thereon, shall give any loan or guarantee, or provide any security or make an acquisition till such default is subsisting.

(7) Every company giving loan or giving guarantee or providing security or making an acquisition of securities shall, from the date of its incorporation, maintain a register in **Form MBP 2** and enter therein separately, the particulars of loans and guarantees given, securities provided and acquisitions made as aforesaid.

(8) The register shall be kept at the registered office of the company and the register shall be preserved permanently and shall be kept in the custody of the company secretary of the company or any other person authorised by the Board for the purpose.

The entries in the register shall be made chronologically in respect of each such transaction within 7 days of making such loan or giving guarantee or providing security or making acquisition.

The extracts from the register maintained may be furnished to any member of the company on payment of such fee as may be prescribed in the Articles of the company which shall not exceed ten rupees for each page.

(9) Nothing contained in this section, except sub-section (1) shall apply to—

- a loan made, guarantee given or security provided by a banking company or an insurance company or a housing finance company in the ordinary course of its business or a company engaged in the business of financing of companies or of providing infrastructural facilities.

- any acquisition made by a non-banking financial company registered under Chapter IIIB of the Reserve Bank of India Act, 1934 and whose principal business is acquisition of securities.
- any acquisition made by a company whose principal business is the acquisition of securities.
- any acquisition of shares allotted in pursuance of clause (a) of sub-section (1) of section 62.

(10) The Central Government may make rules for the purpose of this section from time to time.

(11) If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

[Explanation: “free reserves” means those reserves which, as per latest audited balance sheet of the company, are free for distribution as dividend and shall not include any other amount shown as a reserve or otherwise representing unrealised gains, notional gains or revaluation of assets; or any change in carrying amount of an asset or of a liability recognized in equity, including surplus in statement of profit and loss on measurement of the asset or the liability at fair value.]

6.10 Audit Report

Auditor’s Report - An audit report should be clear, specific and complete, in order that anyone who has an occasion to read it may know exactly what is wrong with the company. An Auditor who gives the shareholders “the means of information” in respect of company’s financial position, does so, at his peril and runs the serious risk of being held judicially to have failed to discharge his duty (Lindley L.J in Re London and General Bank).

The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements.

The auditor’s report should contain a clear written expression of opinion on the financial statements taken as a whole.

(Students may refer Chapter 8 on Audit Report for detailed reporting requirements)

6.11 Disclosure in the Auditor’s Report

The following paragraphs deal with the manner of qualification and the manner of disclosure, if any, to be made in the auditor’s report.

AS-1 – Disclosure of Accounting Policies

In the case of a company, members should qualify their audit reports in case –

- (a) accounting policies required to be disclosed under Revised Schedule VI or any other provisions of the Companies Act, 1956 have not been disclosed (now Schedule III to the Companies Act, 2013), or
- (b) accounts have not been prepared on accrual basis, or
- (c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
- (d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.

In the case of enterprises not governed by the Companies Act, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary.

In the event of non-compliance by enterprises not governed by the Companies Act, in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

In making a qualification/disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

6.12 Joint Audit

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a take - over often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance.

The general **disadvantages** may be the following:

- (i) The fees being shared.
- (ii) Psychological problem where firms of different standing are associated in the joint audit.
- (iii) General superiority complexes of some auditors.
- (iv) Problems of co-ordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

- (a) in respect of the audit work which is not divided among the joint auditors and is carried out

6.41 Advanced Auditing and Professional Ethics

by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

If any matters of the nature referred above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

[Note: Student may refer SA 299 “Responsibility of Joint Auditors” reproduced in “Auditing Pronouncements” for comprehensive knowledge.]

6.13 Audit of Branch Office Accounts

As per section 128(1) of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

It may be noted that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within 7 days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Students may also note that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Sub-section (2) provides that where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred in (1).

Further, **sub-section (8) of section 143 of the Companies Act, 2013**, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either

by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per **Rule 12 of the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a

6.43 Advanced Auditing and Professional Ethics

completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

6.14 Cost Audit

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

Cost Audit: Cost Audit is covered by Section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

As per section 148, the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

It may be noted that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

In this regard, the Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

As per Rule 5 of the Companies (cost records and audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year is required to maintain cost records in **Form CRA-1**. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per clause (vi) to Paragraph 3 of the CARO, 2016, the auditor has to report whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an Auditor within 180 days of the commencement of every financial year. ***However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.*** Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such

appointment with the Central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 days of the commencement of the financial year, whichever is earlier, through electronic mode, in **Form CRA-2**, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

The cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

The cost auditor shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in **Form CRA-3**. He shall forward his duly signed report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

Duty to report on fraud: The provisions of sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply *mutatis mutandis* to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Cost Audit Rules not to apply in certain cases: The requirement for cost audit under these rules shall not be applicable to a company which is covered under rule 3, and,

- (i) whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue; or
- (ii) which is operating from a special economic zone.
- (iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.**

If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

Who can be cost auditor: The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

Students may note that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

It may also be noted that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

Appointment and Remuneration of Cost Auditor: As per rule 14 of the Companies (Audit and Auditors) Rules, 2014,

6.45 Advanced Auditing and Professional Ethics

- (a) in the case of companies which are required to constitute an audit committee-
 - (i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;
 - (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- (b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Qualification, disqualification, rights, duties and obligations of Cost Auditor: The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It may be noted that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

Submission of Cost Audit Report: A company shall within 30 days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in **Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015** along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014. If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

Penal Provisions in case of default: If any default is made in complying with the provisions of this section,

- (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147. (Section 147 is discussed separately in para 6.15);
- (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147. (Section 147 is discussed separately in para 6.15).

[Note: Students may refer Chapter 16 on Cost Audit for more details]

6.15 Punishment for non-compliance

Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:

(1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

(2) If an auditor of a company contravenes any of the provisions of section 139 section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

It may be noted that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

(3) Where an auditor has been convicted under sub-section (2), he shall be liable to:-

- (i) refund the remuneration received by him to the company;
- (ii) and pay for damages to the company statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

(4) The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages the such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

(5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in an fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil criminal as provided in this Act or in any other law for the time being in force, for such act shall be the partner or partners concerned of the audit firm and of the firm jointly and severally.

6.16 Final Accounts Preparation and Presentation

6.16.1 Financial Statements

Statutory Requirements – Central Government to prescribe accounting standards.

Section 133 of the Companies Act, 2013

The Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the

6.47 Advanced Auditing and Professional Ethics

recommendations made by the National Financial Reporting Authority (NFRA).

However, as per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the ICAI in consultation with and after examination of the recommendations made by National Advisory Committee on Accounting Standards (NACAS).

The Central Government has also notified Companies (Indian Accounting Standards) Rules, 2015 dated 16.02.2015 in exercise of the powers conferred by section 133. The said rules list the Indian Accounting Standards (Ind AS) and the class of companies required to comply with the Ind AS while preparation of their financial statements.

Section 129(1) of the Companies Act, 2013, governs the requirements to be satisfied by financial statements. The provisions thereunder, however, are not applicable to an insurance or banking company or a company engaged in the generation or supply of electricity or to any other class of companies for which a form of financial statement has been specified in or under the Act governing such class of companies. The provisions that companies, other than those aforementioned, should comply with are:

(a) That financial statement shall, give a true and fair view of the state of affairs of the company or companies as at the end of financial year, comply with the notified accounting standards notified under section 133 and be in such form or forms specified in Schedule III to the Companies Act, 2013.

(b) That the items contained in such financial statements shall be in accordance with the accounting standards.

The third proviso to section 129(1) of the Act provides that the financial statements not to be treated as not disclosing true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Section 129(2) of the Act, requires the Board of Directors of the company to lay before every annual general meeting the financial statements for the financial year.

Re-opening of accounts on Court's or Tribunal's orders: Section 130 of the Companies Act, 2013 states that a company shall not re-open its books of account and not recast its

financial statements, unless an application in this regard is made by the Central Government, the Income-tax authorities, the Securities and Exchange Board, any other statutory regulatory body or authority or any person concerned and an order is made by a court of competent jurisdiction or the Tribunal to the effect that—

- (i) the relevant earlier accounts were prepared in a fraudulent manner; or*
- (ii) the affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of financial statements.*

However, a notice shall be given by the Court or Tribunal in this regard and shall take into consideration the representations, if any.

Voluntary revision of financial statements or Board's report: Section 131 of the Companies Act, 2013 states that if it appears to the directors of a company that—

- (a) the financial statement of the company; or*
- (b) the report of the Board,*

do not comply with the provisions of section 129 (Financial statement) or section 134 (Financial statement, Board's report, etc.) they may prepare revised financial statement or a revised report in respect of any of the three preceding financial years after obtaining approval of the Tribunal on an application made by the company in such form and manner as may be prescribed and a copy of the order passed by the Tribunal shall be filed with the Registrar.

6.16.2 Consolidated Financial Statement

Section 129(3) of the Act has now made **mandatory** for consolidation of financial statement. It states that where a company has one or more subsidiaries, it shall, in addition to the financial statements provided above, prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner so that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2) above.

The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards. And in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

However, the requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:

- (i) it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available***

with the company, do not object to the company not presenting consolidated financial statements;

(ii) it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and

(iii) its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

The company is also required to attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in **Form AOC-1**.

[Explanation- For the purpose of sub-section (3) of section 129, the word “subsidiary” shall include associate company and joint venture.]

The provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements referred to in section 129(3).

Where the financial statements of the company do not comply with the accounting standards, such companies shall disclose in its financial statements, the following, namely:

- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

The Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of the companies from complying with any of the requirements of this section or the rules, if it is considered necessary to grant such exemption in the public interest and such exemption may be granted either conditionally or unconditionally.

6.16.3 Penalty for contravention

If a company contravenes the provisions of this section:

(a) the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both, and

(b) in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

[Explanation- For the purpose of section 129, except where the context otherwise requires, any

reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.]

6.16.4 Constitution of National Financial Reporting Authority

According to Section 132¹ of the Act, the Central Government may, by notification, constitute a National Financial Reporting Authority to provide for matters relating to accounting and auditing standards for adoption by companies or class of companies under this Act.

However, the central government, vide its notification dated September 18, 2014, clarified that the chairperson and members of “National Advisory Committee on Accounting Standards” shall continue to hold office for a period of one year from the notification date or till the constitution of “National Financial Reporting Authority” whichever is earlier.

6.16.5 Form of the Balance Sheet

Only vertical format of balance sheet and statement of profit and loss is prescribed under Schedule III to the Companies Act, 2013. Only vertical format is allowed and consequently compulsory. There is no option to prepare balance sheet and statement of profit and loss in horizontal format (‘T Form’).

Some of the features of Schedule III are as under:

- (i) The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies act, 2013. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.
- (ii) This Schedule does not recognize presenting information in Schedules. Instead it requires presenting the information in details through notes to account.
- (iii) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts.
- (iv) The corresponding amount for the immediately preceding year for all the items shown in the Financial Statements including notes shall also be given [excluding the cases where first Financial Statements laid before the company (after its incorporation)].

Schedule III to the Companies Act, 2013 –

The Schedule III to the Companies Act, 2013 (brought into force with effect from 1st April, 2014) will apply to all the companies (except to the companies as referred to in the second proviso to section 129(1) of the Companies Act, 2013) uniformly for the financial statements to be prepared for the financial year 2014-15 and onwards.

The requirements of Schedule III do not apply to the Companies excused in the second proviso

¹ Section 132 of the Companies Act, 2013 is not yet notified.

6.51 Advanced Auditing and Professional Ethics

to section 129(1) of the Companies Act, 2013, namely:

- (a) an insurance company, or
- (b) banking company, or
- (c) a company engaged in the generation or supply of electricity, or
- (d) any other class of companies for which a form of financial statement has been specified in or under the Act governing such class of companies.

The Schedule III to the Companies Act, 2013 has been divided into two divisions vide notification dated 06.04.2016. Division I deals with Financial Statements for a company whose Financial Statements are required to comply with the Companies (Accounting Standards) Rules, 2006 and Division II deals with Financial Statements for a company whose financial statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

Division I has been divided as follows:

Part I contains the form in which the Balance Sheet of a company should be drawn up, and states the general instructions as regard to presentation of different assets and liabilities.

Part II contains the form and states the general instructions as regard to preparation and presentation of information in the Statement of Profit and Loss.

General instructions for preparation of Consolidated Financial Statements have also been provided in Schedule III where a company is required to prepare Consolidated Financial Statements. The company shall mutatis mutandis follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss.

Division II has been divided as follows:

Part I contains the form in which the Balance Sheet of a company required to comply with Ind AS and states the general instructions as regard to preparation of Balance Sheet.

Part II contains the form and states the general instructions as regard to preparation of Statement of Profit and Loss.

PART III contain general instructions for preparation of Consolidated Financial Statements.

[Note: Students are required to refer Appendix annexed at the end of this Chapter for detailed understanding of Schedule III to the Companies Act, 2013]

6.17 Significance of True and Fair

The concept of true and fair is a fundamental concept in auditing. The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are

relevant and no material amount, item or transaction has been omitted.

The importance of the concept of true and fair view can also be understood and appreciated from the fact that sections 128, 129 and 143 of the Companies Act, 2013 also discuss this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the Companies Act, 2013 provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term “financial statement” shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) of section 129 shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

- (a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;
- (b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
- (c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

6.53 Advanced Auditing and Professional Ethics

- (d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

In the context of audit of a company, the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of Schedule III to that Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the auditor will have to see that the accounts are drawn up in conformity with the provisions of Schedule III of the Companies Act, 2013 and whether they contain all the matters required to be disclosed therein. In case of companies which are governed by special Acts, the auditor should see whether the disclosure requirements of the governing Act are complied with. It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a 'true and fair' view is a matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see: (i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles, (ii) no material asset is omitted; (iii) the charge, if any, on assets are disclosed; (iv) material liabilities should not be omitted; (v) the statement of profit and loss discloses all the matters required to be disclosed by Part II of Schedule III and the balance sheet has been prepared in accordance with Part I of Schedule III; (vi) accounting policies have been followed consistently; and (vii) all unusual, exceptional or non-recurring items have been disclosed separately.

In this context, it is noteworthy that the Council of the Institute while issuing a clarification regarding authority attached to documents issued by the Institute also observed that, the Companies Act, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 2013 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The pronouncements issued by the Institute include various statements, standards and guidance notes.

6.18 Divisible Profits, Dividends and Reserves

Profit is the central theme for almost all business activities. Decision about the future of the business, i.e., whether to close down, expand or modify largely depend on the trend of profits or losses; investors' interest in a business is also dependent upon the yield that they get. For all these, determination of correct profit is obviously important and, no wonder, it is a matter to which accountants attach great importance. The auditor must necessarily have regard to generally accepted accounting practices, legal provisions and judicial pronouncements in carrying out his duties. Should more profit be distributed than is permissible, because of a wrong process of computation, it may be treated as paying a dividend out of capital which is legally not permissible unless the company is being wound up. Apart from legal consequences, the management of the business would be depleting capital of the company which may have dangerous results.

Reserves can be created only when there is profit. Some reserves can also be utilised to pay dividends. Apart from the specific law governing creation and maintenance of reserves in certain cases, the articles of association of companies generally contain provisions in this respect. In addition, accepted accounting practices suggest situations, where, even in the absence of any specific law, reserves should be maintained. Despite the existence of accounting principles, judicial rulings and legal requirements controversy in these respects cannot be considered to have come to an end. For example, though professional bodies as well as law have tried to distinguish revenue reserves from capital reserves, still there is large scope of disagreement on whether capital reserves are distributable. It is imperative that there should be a clear idea about profit, distributable profit, dividend and reserves. The auditor should, within the broad framework of available guidelines, exercise his own judgement in each case.

A special note in this connection should be taken for depreciation and valuation of stocks, the two major elements influencing the correct determination of profit or loss. These two are related to the valuation of assets of the business which directly and significantly affect the figure of profit or loss. One should be aware of the various possibilities in this regard.

6.18.1 Concept of profit

Like the term "value" in Economics, accountants have used the word 'profit' for many years

6.55 Advanced Auditing and Professional Ethics

without assigning a definite meaning to it. This state of affairs has given rise to much uninformed criticism of accountants and their work; added to this is the difficulty an economist and an accountant differ as to computation of profit of a business.

Economist's concept - Profit is the increase in the value of total net assets of a business over a period of time after making an allowance for any withdrawal or introduction of capital. This is known as the "Increased Net Worth Theory of Profit". It is ascertained by determining the market value on the two accounting dates of all the assets reduced by the amount of liabilities incurred. The increase or reduction in the net worth is the profit or loss for the intervening period.

Accountant's concept - To an accountant, profit is the margin between operating income and associated expenses as related to a given period of time. Nevertheless, he is conscious of the fact that a business is a continuing operation and its wheels do not cease to grind, as is assumed for the purpose of preparing the periodical statements of account. So, while he agrees that these should be prepared in order that proprietors may have periodical reports of the stewardship, he is conscious of their limitations. It is on this account that he is continually striving to perfect his method to evaluate the expenditure which has not resulted in an income so that, on its exclusion the accounts may become more accurate and meaningful.

In this regard some of the ideas which have dominated the thinking of accountants in the past are: the necessity of preserving the monetary value of the proprietary capital originally contributed, the unpredictable nature of the future course of events and sale as an essential step to the emergence of profit. These ideas in due course have developed into a completed fabric of "generally accepted accounting practices" which are stated below:

- (i) The book value of fixed assets should be assessed at their historical cost regardless of their market price.
- (ii) The book value of current assets should be based on their cost or net realisable value whichever is lower.
- (iii) A mere rise in market value is not a profit, but if the asset is a current asset, decline in its market value is a loss.
- (iv) No profits are earned unless the product is sold and cash is received or an enforceable obligation against a debtor is created.
- (v) In general, underestimation of prospective revenue (i.e., conservatism) is commendable: overstatement is not permissible. This is based on the dictum: anticipate no profits, provide for all losses. No a day, concept of procedure is gaining importance over the conservatism.
- (vi) In general, known expenditure or loss even though not incurred should be provided for.
- (vii) Consistency of accounting policy adopted from year to year should be ensured as far as practicable.

On a consideration of the aforementioned practices it would appear that if any of them are disregarded, the accuracy of profits disclosed by the statements of account would be vitiated and elements of guess work and uncertainty would creep in.

6.18.2 Valuation of assets

The question of determination of profits is inextricably bound up with the valuation of assets. Therefore, when the basis of valuation is altered or a wrong basis is adopted, it affects the amount of profit or loss disclosed by the Statement of Profit and Loss. Some of the significant factors which affect the determination of profit are: rate of depreciation of fixed assets, the manner in which expenditure on research is adjusted in the accounts, valuation of work in progress, provision for bad and doubtful debts, etc. The different bases on which assets are valued are briefly explained below to show that the method conventionally followed for the determination of profits does not necessarily give profit which have been actually earned. This is because a lot of estimation enters in determining the value of assets and liabilities:

(i) Fixed assets - The charge for depreciation is always approximate. There are several elements of estimation involved in its computation, e.g., the life of the asset, its residual scrap, value of obsolescence, etc. Further, the charge for depreciation is made merely to amortize the original cost. It may or may not at the end of its useful life, result in accumulating enough liquid resources to replace the asset on account of the increase which may have taken place in the replacement cost.

(ii) Intangible assets - Accounting theory so far has not sufficiently developed to prescribe a uniform method of valuation of intangible assets like goodwill, patent rights, technical know-how, etc. This class of assets is thus treated differently by different industries; sometimes even in the same industry their treatment at different units is not the same.

(iii) Deferred revenue expenditure and other fictitious assets - Again there is no uniformity of treatment of these items. Successful companies write off their preliminary expenses or development expenses, etc. immediately. Less successful ones write them off over a period of years, the argument being that such initial expenditure also benefits future years. The likely issuance of Accounting Standard on "Intangible Assets" would provide the necessary guidance.

(iv) Valuation of Work in Progress- There are several senses in which the words "cost" and "net realisable value" may be construed. The rule that profit must only be taken into account when realised by sale is again responsible for some distortion. Its application logically to companies doing long-term construction contracts may involve a great fluctuation in profits from year to year. AS-2 issued by the Institute deals with uniform approach and practice as regards valuation and presentation of inventories.

Judicial rulings on ascertainment of profits - The fact of the three cases given below should be studied carefully:

In *Re. Spanish Prospecting Co. Ltd.* (1911), the company had contracted to pay a certain salary to some of its staff subject to the condition that they shall not be entitled to draw their salary "except only out of profits" if any, arising from the business of the company. The salary was cumulative. Any arrears were to be payable out of future profits. The company dealt in shares and securities. The company went into liquidation and some of the securities held were sold by the liquidator. It was contended that the proceeds should be credited to the Statement of Profit and Loss (their book value was nil) in order to enable the staff to receive their arrears to salary.

6.57 Advanced Auditing and Professional Ethics

This contention was rejected at first but was upheld by the Court of Appeal. This case establishes the fundamental nature of profit (impliedly the economist's profit).

In *Re. Crabtree Thomas vs. Crabtree* (1912), the testator left his business to be carried on by trustees and to pay thereof to his wife while she lived and on her death, to a residuary legatee. The trustee charged in the accounts depreciation on machinery. It was contended on behalf of the life tenant that the profits before charging depreciation were paid to her. But it was ruled out on the ground that depreciation must be charged on the assets of a business to arrive at the amount of profit.

Edwards vs. Saunton Hotel Co. Ltd. (1942), a director of the company was to be paid by way of remuneration 20% of the profit "available" for distribution each year. It was held that depreciation on assets calculated on the straight line method must be deducted from the surplus to arrive at the amount of profit, 20% whereof was payable to the director, but the income tax payable by the company was not to be deducted.

6.18.3 Depreciation under Section 123 of the Companies Act, 2013 read with Schedule II to the Companies Act, 2013

Section 123 of the Act, provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in a manner prescribed under Schedule II "Useful lives to compute Depreciation", to the Companies Act, 2013.

The useful life or residual value of any specific asset as notified for accounting purpose by a Regulatory Authority constituted under an Act of Parliament or by the Central Government intend to be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of Schedule II.

The Schedule II to the Companies Act, 2013 needs disclosure in the financial statements about the depreciation method used and the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule II. [Discussed later in detail under Para 6.19 Depreciation].

6.18.4 Law relating to dividends -

6.18.4.1 Sources of dividends - The Companies Act, 2013 lays down the law relating to distribution of profits by making certain provisions under Section 123. Accordingly, dividend cannot be declared or paid by a company for any financial year except:

- (a) out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Section 123(2), or
- (b) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or
- (c) out of the balances of profit mentioned in (a) and (b) above; or
- (d) out of money provided by the Central Government or a State Government for the payment of dividend by the company pursuant to the guarantee given by that Government.

6.18.4.2 Dividends out of current profits- Transfer to Reserves is optional – The first proviso to Section 123(1) of the Act provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend.

6.18.4.3 Dividends out of past profits - The second proviso to Section 123(1) of the Companies Act, 2013 read with the Companies (Declaration and Payment of Dividend) Rules, 2014 provides that in the event of inadequacy or absence of profits in any year, dividend may be declared by a company for that year out of surplus subject to the fulfillment of following conditions that:

(i) The rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year.

It is also provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(ii) The total amount to be drawn from such accumulated profits shall not exceed an amount equal to one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(iii) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(iv) The balance of reserves after such withdrawal shall not fall below 15% of its paid-up share capital as appearing in the latest audited financial statement.

The fourth proviso to section 123(1) provides that no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year(s) are set off against profit of the company for the current year.

No dividend from Reserves other than Free Reserves- It is further provided under third proviso to Section 123(1) of the Companies Act, 2013 that no dividend shall be declared or paid by a company from its reserves other than free reserves.

6.18.4.4 Dividends includes Interim dividend- As per Section 2(35) of the Companies Act, 2013, dividend has been defined to include any interim dividend also.

6.18.4.5 Dividend policy and related financial considerations - Normally an auditor, in the discharge of his duties is not concerned with the policy about dividends. He is merely concerned with the legality and actual payment of the dividend. The basis of legality is provided by the Companies Act, 2013 and the related Articles of Association. However, sometimes auditors are consulted in the matter of deciding upon the quantum of dividend that can be distributed by a company. Apart from this, Chartered Accountants as such also act as consultants to various companies on a number of matters, including dividend. The basic decision about the dividend is that of the management; the shareholders do not have the authority to enhance the sum proposed by the directors unless the articles allow such a procedure. On the other hand, the management, because of its very thorough and intimate knowledge of the financial state of

affairs of the company and of the business environment, is considered to be the best equipped to deal with the matter.

Dividend is a phenomenon involved with the question of financial management of the company, rationality or feelings of the shareholders and other allied factors; it is therefore very difficult to lay down any definite policy in this regard. However, as a guiding rule a broad frame of policy has often been adopted by companies for guidance in deciding each year the quantum of dividend having regard to the specific situations faced by the company in the concerned year or situations that are in offing. In deciding upon a policy of dividend the financial considerations generally get the place of prominence, though the aspects of shareholders' aspirations are also taken into consideration. A balance is generally struck to bring about compromise and adjustment between these without unduly impairing the financial state of the company. In this context, it should be appreciated that the amount of the profit available as dividend has competing claimants. It is a source of finance so far as the company is concerned. This can often be very profitably employed to finance expansion or diversification or for setting right the adverse working capital or liquidity position.

As a general proposition, the following are determinants of dividend policy:

1. Nature of earnings.
2. Re-investment alternative.
3. Dividends and liquidity.
4. Dividends and working capital.
5. Dividends and new capital requirements.
6. Dividends and market value of shares.
7. Tax brackets of shareholders.
8. Stability of dividend.

6.18.4.6 Payment of Dividends

(1) Dividends once declared become the liability of the company and must be paid within 30 days from the date of declaration. Any failure to do so attracts a penalty for the various persons associated with the management [Section 127].

(2) Payment of dividend on any share should be made only to the registered shareholder of such share or to his order or to his banker. Dividends are not payable except in cash; or by cheque or warrant; or in any electronic mode to the shareholder entitled to the payment of the dividend.

But the profits or reserves can be capitalised for purpose of issuing fully paid-up bonus shares subject to the guidelines issued by the SEBI also they may be applied for paying up any amount for the time being unpaid on any share held by the members of the company.

(3) A company may, if so authorised by its articles, pay dividends in proportion to the amount paid-up on each share in accordance with Section 51.

(4) The Board may deduct from any dividend payable to any member all sums of money, if any, presently payable by him to the company on account of calls or otherwise in relation to the shares of the company [Table F of Schedule I to the Companies Act, 2013].

Deposit of amount of Dividend in separate bank account - The amount of the dividend, including interim dividend, should be deposited in a scheduled bank in a separate account within 5 days from the date of declaration of such dividend.

As per Section 123(6) of the Act, a company which fails to comply with the provisions of section 73 (matters to be followed while inviting, accepting or renewing deposits under the new Companies Act, 2013 from the public), and section 74² (matters to be followed for repayment of deposits etc. before the commencement of this Companies Act, 2013) shall not, so long as such failure continues, declare any dividend on its equity shares.

6.18.4.7 Punishment for failure to distribute dividends - According to Section 127 of the Companies Act, 2013, where a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted, within 30 days from the date of declaration to any shareholder entitled to the payment of the dividend, following shall be punishable:

- (i) every director of the company, if he is knowingly a party to the default, be punishable with imprisonment which may extend to 2 years and with fine which shall not be less than one thousand rupees for every day during which such default continues and,
- (ii) the company shall be liable to pay simple interest at the rate of 18% per annum during the period for which such default continues.

Proviso to Section 127 of the Act provides that no offence under this section shall be deemed to have been committed:-

- (a) where the dividend could not be paid by reason of the operation of any law;
- (b) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has been communicated to him;
- (c) where there is a dispute regarding the right to receive the dividend;
- (d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or
- (e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period under this section was not due to any default on the part of the company.

6.18.4.8 Unpaid Dividend Account [Section 124]

Section 124 of the Act provides that dividend declared which remains unpaid or unclaimed within 30 days from the date of declaration of such dividend shall be transferred by the company to a special account called "Unpaid Dividend Account" opened in any scheduled bank. Such transfer

² Only Sub-section (1) of Section 74 of the Companies Act, 2013 is enforced till date.

6.61 Advanced Auditing and Professional Ethics

shall be made within 7 days from the date of expiry of the said period of 30 days. In case of any default in transferring the amount unpaid/ unclaimed dividend to the Unpaid Dividend Account, the company shall pay interest at the rate of 12% per annum on the amount not transferred. The interest accrue on such amount shall endure to the benefit of the members of the company in proportion to the amount remaining unpaid to them.

Any person claiming to be entitled to any of the money transferred to the Unpaid Dividend Account of the company may apply to the company for the payment of the money claimed.

Obligation to place details of transfer to Unpaid Dividend Account on website- The company is required to prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person within a period of 90 days of making any transfer of an amount to the Unpaid Dividend Account and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

Unpaid or unclaimed amount of Unpaid Dividend Account- Any money transferred to Unpaid Dividend Account remains unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund.

The company shall send a statement of the details of such transfer to the authority in the **Form DIV 5** which administers the said fund and that authority shall issue a receipt to the company an evidence of such transfer.

All shares in respect of which unpaid or unclaimed dividend has been transferred shall also be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed. Any claimant of shares transferred shall be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.

Sub-section (7) of Section 124 of the Act provides that the company shall be punishable with fine which shall not be less than five lakh rupees but which may be extend to twenty-five lakh rupees. Every officer of the company who is in default shall be punishable with fine which shall not be less than one lakh rupees but which may be extend to five lakh rupees.

6.18.4.9 Establishment of Investor Education and Protection Fund [Section 125³]

(1) The Central Government shall establish a fund to be called the Investor Education and Protection Fund (hereafter in this section referred to as the "Fund").

(2) There shall be credited to the Fund the following amounts, namely:

(a) the amount given by the Central Government by way of grants after due appropriation made by Parliament by law in this behalf for being utilised for the purposes of the Fund;

³ Some part of section 125 of the Companies Act, 2013 enforced with effect from 07.09.2016.

- (b) donations given to the Fund by the Central Government, State Governments, companies or any other institution for the purposes of the Fund;
- (c) the amount in the Unpaid Dividend Account of companies transferred to the Fund under sub-section (5) of section 124 of the Companies Act, 2013;
- (d) the amount in the general revenue account of the Central Government which had been transferred to that account under sub-section (5) of section 205A of the Companies Act, 1956, as it stood immediately before the commencement of the Companies (Amendment) Act, 1999, and remaining unpaid or unclaimed on the commencement of this Act;
- (e) the amount lying in the Investor Education and Protection Fund under section 205C of the Companies Act, 1956;
- (f) the interest or other income received out of investments made from the Fund;
- (g) the amount received under sub-section (4) of section 38;
- (h) the application money received by companies for allotment of any securities and due for refund;
- (i) matured deposits with companies other than banking companies;
- (j) matured debentures with companies;
- (k) interest accrued on the amounts referred to in clauses (h) to (j);
- (l) sale proceeds of fractional shares arising out of issuance of bonus shares, merger and amalgamation for seven or more years;
- (m) redemption amount of preference shares remaining unpaid or unclaimed for seven or more years; and
- (n) such other amount as may be prescribed.

It is provided that no such amounts referred to in clauses (h) to (j) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

(3) The Fund shall be utilised for the following purposes in accordance with such rules as may be prescribed:-

- (a) the refund in respect of unclaimed dividends, matured deposits, matured debentures, the application money due for refund and interest thereon;
- (b) promotion of investors' education, awareness and protection;
- (c) distribution of any disgorged amount among eligible and identifiable applicants for shares or debentures, shareholders, debenture-holders or depositors who have suffered losses due to wrong actions by any person, in accordance with the orders made by the Court which had ordered disgorgement;

6.63 Advanced Auditing and Professional Ethics

- (d) reimbursement of legal expenses incurred in pursuing class action suits under sections 37 and 245⁴ by members, debenture-holders or depositors as may be sanctioned by the Tribunal; and
- (e) any other purpose incidental thereto.

It is provided that the person whose amounts referred to in clauses (a) to (d) of sub-section (2) of section 205C of the Companies Act, 1956, transferred to Investor Education and Protection Fund, after the expiry of the period of seven years as per provisions of the Companies Act, 1956, shall be entitled to get refund out of the Fund in respect of such claims in accordance with rules made under this section.

Explanation- The disgorged amount refers to the amount received through disgorgement or disposal of securities.

- (4) Any person claiming to be entitled to the amount referred in section 125(2) may apply to the authority constituted under section 125(5) for the payment of the money claimed.
- (5) The Central Government shall constitute, by notification, an authority for administration of the fund consisting of a chairperson and such other members, not exceeding seven and a chief executive officer, as the Central Government may appoint.
- (6) The manner of administration of the Fund, appointment of chairperson, members and chief executive officer, holding of meetings of the authority shall be in accordance with such rules as may be prescribed.
- (7) The Central Government may provide to the authority such offices, officers, employees and other resources in accordance with such rules as may be prescribed.
- (8) The authority shall administer the Fund and maintain separate accounts and other relevant records in relation to the Fund in such form as may be prescribed after consultation with the C&AG of India.
- (9) It shall be competent for the authority constituted under sub-section (5) to spend money out of the Fund for carrying out the objects specified in sub-section (3) of 125.

The accounts of the Investor Education and Protection Fund is required to be audited by the C&AG of India at such interval as may be specified by him and such audited accounts together with the audit report thereon shall be forwarded annually by the authority to the Central Government.

The authority is required to prepare in such form and at such time for each financial year as may be prescribed its annual report giving a full account of its activities during the financial year and forward a copy thereof to the Central Government. The Central Government shall cause the annual report and the audit report given by the C&AG of India to be laid before each House of Parliament.

⁴ Section 245 of the Companies Act, 2013 is not yet enforced.

6.18.4.10 Right to dividend, rights shares and bonus shares to be held in abeyance pending registration of transfer of shares- As per section 126 of the Act, payment of dividend and allotment of bonus and right shares to the transferee to be held in abeyance till the title to shares is decided. This section requires that where any instrument of transfer of shares has been delivered to the company for registration and the transfer of such shares has not been registered by the company, it shall transfer the dividend in relation to such shares to the special account referred to in section 124 i.e. Unpaid Dividend Account unless the company is authorised by the registered holder of such shares in writing to pay such dividend to the transferee specified in such instrument of transfer. Further, the company shall also keep in abeyance in relation to such shares, any offer of right shares and any issue of fully paid up bonus shares.

6.18.4.11 Power to close register of members or debenture-holders or other security holders- As per section 91 of the Act, a company may close the register of members or the register of debenture-holders or the register of other security holders for any period or periods not exceeding in the aggregate 45 days in each year, but not exceeding 30 days at any one time, subject to giving of previous notice of at least 7 days or such lesser period as may be specified by Securities and Exchange Board for listed companies or the companies which intend to get their securities listed, in such manner as may be prescribed.

The auditor may take the following steps to ensure that the dividend has been paid only out of profits:

- (a) Check whether dividend was declared out of profits arrived at after providing for depreciation as per Section 123(2).
- (b) Check whether:
 - (i) the depreciation was provided according to provisions of Schedule II to the Companies Act, 2013.
 - (ii) a board resolution recommending dividend was passed.
 - (iii) the dividend was declared only in the annual general meeting.
 - (iv) no dividend declared in general meeting exceeds the amount recommended by the Board.
 - (v) amount paid or credited as paid on a share in advance of calls is not treated for the purpose of this regulation as paid on the share.
 - (vi) register of members was closed as per the provisions of section 91 of the Companies Act, 2013.
 - (vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or to their order (Section 127).
 - (viii) Amount of dividend deposited in a separate bank account within 5 days from the date of declaration of dividend.
 - (ix) intimation sent to stock exchange, in case of listed company.

- (x) there were any complaints regarding non-payment or delay in payment of dividend? If, so, whether corrective action was taken.

6.18.4.12 Interim Dividend - The definition of term dividend has been modified to include interim dividend also. Interim dividend stands at par with the final dividend. Therefore, all aforesaid requirements applicable in case of final dividend would also apply to interim dividend.

The Board of Directors of a company may declare interim dividend during the financial year out of the surplus in the Statement of profit and loss and out of profits of the financial year in which such interim dividend is sought to be declared. Further, if in a case, the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding 3 financial years.

6.18.4.13 Payment of dividend and the Income tax Act - Payment of dividends by a company though basically governed by the provisions of the Companies Act, has to reckon with a number of provisions contained in the Income tax Act, having direct or indirect relevance to the determination of the amount of dividend. The Companies Act, 2013 has prescribed the sources from which dividend may be declared/ paid in Section 123. In particular it requires provision for depreciation, setting off of past losses etc. It also provides for the circumstances under which dividend can be paid out of past profits. The manner of payment of the dividend is also provided for in the Companies Act. It may be mentioned that any deviation from these provisions will render the dividend illegal. The payment of dividend is a corporate phenomenon based on accounting, financial and legal considerations. The accounting and legal considerations are highly related. In determining the accounting profit, as indicated above a number of provisions from the Income tax Act have got to be considered. For example, distributable profit of a company gets conditioned by the requirements to create and retain reserves e.g. investment allowance reserves. It may be pointed out that any departure from the provisions of the Income tax Act will not make the payment of dividend illegal but may increase the tax liability of the company.

6.18.4.14 Should all fictitious assets be written off before distribution of dividends? - The Accounting Standards Board of ICAI has issued a guidance note on terms used in financial statements where the term 'fictitious asset' has been described as an item grouped under assets in a balance sheet which has no real value. The guidance note cites the example of the debit balance of the statement of profit and loss. We can also give other examples like, (1) Goodwill recorded at a particular figure whereas the company may have no goodwill at all in the ordinary commercial sense, (2) Patents appearing in the balance sheet which in fact are useless.

There is no mandatory rule in accounting or any legal requirement that fictitious assets must be written off before declaration of dividend. This is more in the nature of preferable practice but is not mandatory in its nature. Accordingly it may be said that though writing off of fictitious assets on a proper accounting consideration is desirable, it is not mandatory. However, the following points must be noted in this regard:

If there exists debit balance in the Statement of profit and loss, depreciation, if any, contained therein should first be set off before declaration of dividend out of current profits.

In the case of *Verner vs. The General Commercial Investment Trust Ltd.*, it was held that a company may pay dividends if it is solvent and is acting within its articles that distribution of dividend is permissible if there exists revenue surplus even though some portion of the value of the assets disclosed in the balance sheet may turn out to be fictitious.

6.18.4.15 Audit procedure for “Payment of Dividend”: The Auditor should obtain appropriate audit evidence as regard to audit of payment of dividends. The procedure includes the following:

- (i) Check that all the rules and regulations concerning the declaration or payment of dividends have been complied with.
- (ii) Examine that the accounting and disclosure procedure has been complied with related to the declaration and payment of dividend like depreciation has been provided before declaration, disclosure has been made by way of notes to the accounts etc.
- (iii) Scrutinize that the dividends have been declared or paid only out of distributable profit i.e. profits for the current year for which dividend is declared, or accumulated profits of the previous years, or money provided by the Central or State Government as per Section 123(1) of the Act.
- (iv) Inspect that the dividend has been paid only out of “free reserves” i.e. the reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend except- any amount representing unrealized gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or any change in carrying amount of an asset or of a liability recognized in equity, including surplus in statement of profit and loss on measurement of the asset or the liability at fair value, as laid down under third proviso to Section 123(1) read with Section 2(43) of the Act.
- (v) If dividend has been paid out of accumulated profits, earned by it in previous years and transferred to the reserves, in case of inadequacy or absence of profits in any financial years, verify that the rules related to such distribution has been complied i.e. the maximum amount allowable to be distributed as a dividend in case of inadequate or no profit as required by second proviso to Section 123(1) of the Act.
- (vi) Verify that the dividend recommended by the Board has been approved by the members at the annual general meeting.
- (vii) Verify that the dividend has been transferred to the separate scheduled bank account within 5 days from the declaration of such dividend as required by Section 123(4) of the Act.
- (viii) Verify that the dividend has been paid within 30 days from the declaration. If in case the dividend has not been claimed or paid within 30 days from the declaration, verify that the unpaid or unclaimed dividend amount has been transferred to a special account called unpaid dividend account as per Section 124(1) of the Act.
- (ix) Verify that the company has prepared a statement within a period of 90 days of making any transfer of an amount to the Unpaid Dividend Account containing the names, their last

6.67 Advanced Auditing and Professional Ethics

known addresses and the unpaid dividend to be paid to each person, and have placed it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose as required under Section 124(2) of the Act.

(x) Check the procedures that have been followed for the payment of unclaimed dividend out of unpaid dividend account.

(xi) Verify that, if any money transferred to Unpaid Dividend Account has remained unpaid or unclaimed for a period of 7 years from the date of such transfer then, whether it has been transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund established under section 125(1) of the Act and a statement regarding such transfer has also been sent to the authority which administers such fund.

(xii) In case the company has outsourced the activity to the Service Organisation, check that all the compliances with laws, regulations, accounting and disclosure related to the dividends have been made appropriately.

6.18.5 Reserves - The term “reserves” is not defined in Companies Act, 2013. But the term “free reserves” has been defined under section 2(43) of the Act as means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend except any amount representing unrealized gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or any change in carrying amount of an asset or of a liability recognized in equity, including surplus in statement of profit and loss on measurement of the asset or the liability at fair value. Further, as per the relevant extract of the Schedule III to the Companies Act, 2013, “Reserve” has been classified as capital reserve, capital redemption reserve, securities premium reserve, debenture redemption reserve, revaluation reserve, share options outstanding account and other reserves. The Guidance Note on Terms used in Financial Statements issued by the Institute of Chartered Accountants of India defines Reserves as the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types: (a) Capital Reserves and (b) Revenue Reserves.

Such a distinction is essential for disclosing in the balance sheet the amount by which the equity of the shareholders has increased with the accumulation of undistributed profits. The distribution is carried further by segregating the reserve which is made up of fortuitous gains, unconnected with business activity (e.g., appreciation in values of fixed assets, receipts on account of share premiums), from those appropriated out of profits for credit to revenue reserve; the first is described as a capital reserve and the second merely as a reserve. The Companies Act does not specify the categories of accretions to the shareholders funds which are to be credited to the Capital Reserve, except indirectly by providing that the amounts, which in the opinion of directors cannot be distributed as a dividend through the Statement of Profit and Loss are to be credited to such a reserve. The language of the provision appears to suggest that directors are vested with an unrestricted right to decide which of the amounts to be credited to the Capital

Reserve subject only to provisions of the Act as regards certain funds not being available for distribution as dividend. But, it is not so, for they cannot violate the accepted principles of accountancy which determine whether or not an item of income is capital or revenue. It may also be remembered that an appropriation once made can be revoked.

The following are examples of amounts retained in the business that are credited to one reserve account or another:

- (1) Securities Premium Reserve (Capital Reserve).
- (2) Capital Redemption Reserve created in pursuance of provision contained in Section 55 of the Companies Act, 2013 (Capital Reserve).
- (3) Debenture Redemption Reserve created in pursuance of provision contained in Section 71 of the Companies Act, 2013 (Capital Reserve).
- (4) Profit on reissue of forfeited share (Capital Reserve).
- (5) Free Reserve available for distribution of dividend (Revenue Reserve).

Attention of the students is drawn to the provisions of Section 123 of the Companies Act, 2013, discussed earlier, about restrictions in the utilisation of past profit kept in reserves for dividend purposes.

6.18.6 Deferred Taxation

It is a common experience that the profit or loss as per the Statement of Profit and Loss will be different from the income ultimately assessed to income tax. It is also generally different from the income shown in the tax-return submitted to 'tax authorities'. Consequently the taxation liability that is provided for in the accounts does not bear any direct relationship to the profit disclosed and readers of such account are left to guess the reasons. For instance, income tax should be treated on the same footing as is done in case of other expenses i.e., accounted for on accrual basis. From a management point of view income tax is an item of expense rather than an appropriation of pre-tax profit. AS-22 on "Accounting for Taxes on Income" now requires that tax should be treated as an expense. Students are advised to go through AS-22 on "Accounting for Taxes on Income" for comprehensive understanding.

6.18.7 Non-provision of tax in the accounts

The Council of the Institute of Chartered Accountants of India has taken note of the fact that there is a practice prevalent whereby companies do not make provision for tax even when such a liability is anticipated. It has expressed the view that on an overall consideration of the relevant provisions of law, non-provision for tax (where a liability is anticipated) would amount to contravention of the provisions of Sections 128 and 129 of the Companies Act, 2013. Accordingly, it is necessary for the auditor to qualify his report and such qualification should bring out the manner in which the accounts do not disclose a "true and fair" view of the state of affairs of the company and the profit or loss of the company. An example of the manner in which the report on the balance sheet and the Statement of Profit and Loss may be qualified in this respect is given below:

“The company has not provided for taxation in respect of its profits and the estimated aggregate amount of taxation not so provided for is ₹..... including ₹..... for the Year ended onTo the extent of such non-provision for the year, the profits of the Company for the financial year under report have been overstated and to the extent of such aggregate non provision, the reserves of the company appearing in the said balance sheet have been overstated and the current liabilities and provisions appearing in the said balance sheet have been understated”.

6.19 Depreciation

Section 123 prohibits a company from declaring dividend out of its profits before providing for depreciation in the manner laid down in the section.

Section 123 provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Schedule II “Useful lives to compute Depreciation”, to the Companies Act, 2013.

Schedule II to the Act, provides that useful life of an asset shall not ordinarily be different from the useful life specified in Part ‘C’ to the said Schedule and the residual value of an asset shall not be more than 5% of the original cost of the asset. If a company does not use the useful life or residual value of the asset as provided in the Schedule II, then justification for the difference shall be disclosed in its financial statement.

Where during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such asset shall be calculated on a pro rata basis from the date of such addition, or as the case may be, upto the date on which such asset has been sold, discarded, demolished or destroyed.

If an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

The useful life or residual value of any specific asset as notified for accounting purpose by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of Schedule II.

The Schedule II to the Companies Act, 2013 needs disclosure in the financial statements about the depreciation method used and the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule II.

Schedule III “General Considerations for preparation of Balance Sheet and Statement of Profit and Loss of a Company”, to the Companies Act, 2013, requires separate disclosure of depreciation charged and impairment losses/reversals along with a reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments.

Section 123(1) of the Companies Act, 2013 also prescribes that if a company has not provided for depreciation for any previous financial year it shall, before declaring, or paying dividend, provide for such depreciation:

- (a) either out of the profits of that financial year, or
- (b) out of the profits of any other previous financial year or years.

The implication of this provision is that if, for example, the profits of a company for the year ending 31st March, 2014 are proposed to be distributed, and it is found that due to inadequacy of profits no provision for depreciation had been made for the year ended 31st March, 2013 it would be necessary to make provisions in respect of the depreciation, for the year ended 31st March, 2013 as well as 2014 and only the balance of the profits for the year 31st March, 2014 would be available for distribution as a dividend.

Ascertainment of depreciation for computing net profits for the purpose of managerial remuneration: Under Section 197(1) of the Companies Act, 2013, depreciation calculated in the manner specified in Section 198 of the Companies Act, 2013 must be deducted for arriving at the amount of net profits, on which remuneration payable to managerial personnel is to be calculated.

ANNEXURE

Schedule III to the Companies Act, 2013

(See section 129)

Division I

Financial Statements for a company whose Financial Statements are required to comply with the Companies (Accounting Standards) Rules, 2006.

GENERAL INSTRUCTION FOR PREPARATION OF BALANCE SHEET AND STATEMENT OF PROFIT AND LOSS OF A COMPANY

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes *inter se*, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.
2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.
3. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or dis-aggregations of items recognized in those statements and (b) information about items that do not qualify for recognition in those statements.
(ii) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.
4. (i) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:

Turnover	Rounding off
(a) less than one hundred crore rupees	to the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(b) one hundred crore rupees or more	to the nearest, lakhs, millions or crores, or decimals thereof.

- (ii) Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.
- Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.
 - For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note: This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as “Financial Statements” for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company’s financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I – BALANCE SHEET

Name of the Company.....

Balance Sheet as at.....

(Rupees in.....)

				<i>Figures as at the end of current reporting period</i>	<i>Figures as at the end of previous reporting period</i>
		<i>Particulars</i>	<i>Note No.</i>	<i>3</i>	<i>4</i>
		1	2	3	4
		EQUITY AND LIABILITIES			
		Shareholders' funds			
1.	a	Share capital			
	b	Reserves and Surplus			
	c	Money received against share warrants			
2.		Share application money pending allotment			
3.		Non-current liabilities			
	a	Long-term borrowings			

6.73 Advanced Auditing and Professional Ethics

4.	b	Deferred tax liabilities (Net)				
	c	Other long term liabilities				
	d	Long-term provisions				
		Current liabilities				
	a	Short-term borrowings				
	b	Trade Payables (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises.				
	c	Other current liabilities				
	d	Short-term provisions				
		Total				
1		ASSETS				
		Non-current assets				
		a	Fixed assets			
		i	Tangible assets			
		ii	Intangible assets			
		iii	Capital Work-in-progress			
		iv	Intangible assets under development			
		b	Non-current investments			
		c	Deferred tax assets (Net)			
		d	Long-term loans and advances			
		e	Other non-current assets			
	2		Current assets			
			a	Current investments		
			b	Inventories		
		c	Trade receivables			
		d	Cash and cash equivalents			
		e	Short-term loans and advances			
	f	Other current assets				
		Total				

See accompanying notes to Financial Statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realized within twelve months after the reporting date; or
 - (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be settled in the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within twelve months after the reporting date; or
 - (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A company shall disclose the following in the notes to accounts:

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

- (a) the number and amount of shares authorized;
- (b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
- (c) par value per share;

6.75 Advanced Auditing and Professional Ethics

- (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
- (e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
- (f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
- (g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;
- (h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
- (i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
 - (A) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
 - (B) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
 - (C) Aggregate number and class of shares bought back.
- (j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.
- (k) calls unpaid (showing aggregate value of calls unpaid by directors and officers)
- (l) forfeited shares (amount originally paid up)

B. Reserves and Surplus

- (i) Reserves and Surplus shall be classified as:
 - (a) Capital Reserves;
 - (b) Capital Redemption Reserve;
 - (c) Securities Premium Reserve;
 - (d) Debenture Redemption Reserve;
 - (e) Revaluation Reserve;
 - (f) Share Options Outstanding Account;
 - (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

- (ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.
- (iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

- (i) Long-term borrowings shall be classified as:
 - (a) Bonds/debentures.
 - (b) Term loans
 - (A) From banks.
 - (B) From other parties
 - (c) Deferred payment liabilities.
 - (d) Deposits.
 - (e) Loans and advances from related parties.
 - (f) Long term maturities of finance lease obligations
 - (g) Other loans and advances (specify nature).
- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.
- (v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.
- (vi) Terms of repayment of term loans and other loans shall be stated.
- (vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long Term Liabilities

Other Long-term Liabilities shall be classified as:

- (a) Trade payables

6.77 Advanced Auditing and Professional Ethics

(b) Others

E. Long-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

F. Short-term borrowings

(i) Short-term borrowings shall be classified as:

- (a) Loans repayable on demand
 - (A) From banks
 - (B) From other parties
- (b) Loans and advances from related parties.
- (c) Deposits.
- (d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

FA. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:

- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
- (b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;
- (c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
- (d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and
- (e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the

purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts shall be classified as:

- (a) Current maturities of long-term debt;
- (b) Current maturities of finance lease obligations;
- (c) Interest accrued but not due on borrowings;
- (d) Interest accrued and due on borrowings;
- (e) Income received in advance;
- (f) Unpaid dividends
- (g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'
- (h) Unpaid matured deposits and interest accrued thereon
- (i) Unpaid matured debentures and interest accrued thereon
- (j) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

6.79 Advanced Auditing and Professional Ethics

I. Tangible assets

- (i) Classification shall be given as:
 - (a) Land.
 - (b) Buildings.
 - (c) Plant and Equipment.
 - (d) Furniture and Fixtures.
 - (e) Vehicles.
 - (f) Office equipment.
 - (g) Others (specify nature).
- (ii) Assets under lease shall be separately specified under each class of asset.
- (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.
- (iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible assets

- (i) Classification shall be given as:
 - (a) Goodwill.
 - (b) Brands /trademarks.
 - (c) Computer software.
 - (d) Mastheads and publishing titles.
 - (e) Mining rights.
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
 - (g) Recipes, formulae, models, designs and prototypes.
 - (h) Licenses and franchise.
 - (i) Others (specify nature).

- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.
- (iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
 - (a) Investment property;
 - (b) Investments in Equity Instruments;
 - (c) Investments in preference shares
 - (d) Investments in Government or trust securities;
 - (e) Investments in debentures or bonds;
 - (f) Investments in Mutual Funds;
 - (g) Investments in partnership firms
 - (h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments.

6.81 Advanced Auditing and Professional Ethics

L. Long-term loans and advances

- (i) Long-term loans and advances shall be classified as:
 - (a) Capital Advances;
 - (b) Security Deposits;
 - (c) Loans and advances to related parties (giving details thereof);
 - (d) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

- (i) Long Term Trade Receivables (including trade receivables on deferred credit terms);
- (ii) Others (specify nature)
- (iii) Long term Trade Receivables, shall be sub-classified as:
 - (a) (A) Secured, considered good;
 - (B) Unsecured considered good;
 - (C) Doubtful
 - (b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
 - (c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;

- (b) Investment in Preference Shares
- (c) Investments in government or trust securities;
- (d) Investments in debentures or bonds;
- (e) Investments in Mutual Funds;
- (f) Investments in partnership firms
- (g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments
 - (b) Aggregate amount of quoted investments and market value thereof;
 - (c) Aggregate amount of unquoted investments;
 - (d) Aggregate provision made for diminution in value of investments.

O. Inventories

- (i) Inventories shall be classified as:
 - (a) Raw materials;
 - (b) Work-in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) Stores and spares;
 - (f) Loose tools;
 - (g) Others (specify nature).
- (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
- (iii) Mode of valuation shall be stated.

6.83 Advanced Auditing and Professional Ethics

P. Trade Receivables

- (i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.
- (ii) Trade receivables shall be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and cash equivalents

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).
- (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than 12 months maturity shall be disclosed separately.

R. Short-term loans and advances

- (i) Short-term loans and advances shall be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.

- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments (to the extent not provided for)

- (i) Contingent liabilities shall be classified as:
 - (a) Claims against the company not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the company is contingently liable
- (ii) Commitments shall be classified as:
 - (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
 - (b) Uncalled liability on shares and other investments partly paid
 - (c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

6.85 Advanced Auditing and Professional Ethics

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company.....

Profit and loss statement for the year ended

(Rupees in.....)

Particulars		Note No.	Figures for the current reporting period	Figures for the previous reporting period
1		2	3	4
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Revenue (I + II)		xxx	xxx
IV.	Expenses:		xxx	xxx
	Cost of materials consumed		xxx	xxx
	Purchases of Stock-in-Trade		xxx	xxx
	Changes in inventories of finished goods		xxx	xxx
	work-in-progress		xxx	xxx
	and Stock-in-Trade		xxx	xxx
	Employee benefits expense		xxx	xxx
	Finance costs		xxx	xxx
	Depreciation and amortization expense		xxx	xxx
	Other expenses		xxx	xxx
	Total expenses		xxx	xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)		xxx	xxx
VI.	Exceptional items		xxx	xxx
VII.	Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII.	Extraordinary Items		xxx	xxx
IX.	Profit before tax (VII- VIII)		xxx	xxx
X	Tax expense:			
	(1) Current tax		xxx	xxx
	(2) Deferred tax		xxx	xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	Xxx
XII	Profit/(loss) from discontinuing operations		xxx	Xxx

XIII	Tax expense of discontinuing operations		xxx	Xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	Xxx
XV	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI	Earnings per equity share:			
	(1) Basic		xxx	xxx
	(2) Diluted		xxx	xxx

See accompanying notes to the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (ii) of Clause (40) of Section 2 in like manner as they apply to a statement of profit and loss.
2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from
 - (a) Sale of products;
 - (b) Sale of services;
 - (c) Other operating revenues;
 Less:
 - (d) Excise duty.
- (B) In respect of a finance company, revenue from operations shall include revenue from
 - (a) Interest; and
 - (b) Other financial services

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as:

- (a) Interest expense;
- (b) Other borrowing costs;
- (c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as:

- (a) Interest Income (in case of a company other than a finance company);
- (b) Dividend Income;

6.87 Advanced Auditing and Professional Ethics

- (c) Net gain/loss on sale of investments
- (d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:

- (i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].
 - (b) Depreciation and amortization expense;
 - (c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000, whichever is higher;
 - (d) Interest Income;
 - (e) Interest Expense;
 - (f) Dividend Income;
 - (g) Net gain/ loss on sale of investments;
 - (h) Adjustments to the carrying amount of investments;
 - (i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
 - (j) Payments to the auditor as
 - (a) auditor,
 - (b) for taxation matters,
 - (c) for company law matters,
 - (d) for management services,
 - (e) for other services,
 - (f) for reimbursement of expenses;
 - (k) In case of companies covered u/s 135, amount of expenditure incurred on corporate social responsibility activities.
 - (l) Details of items of exceptional and extraordinary nature;
 - (m) Prior period items;
- (ii) (a) In the case of manufacturing companies,
 - (1) Raw materials under broad heads.
 - (2) goods purchased under broad heads.

- (b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.
- (c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.
- (d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.
- (e) In the case of other companies, gross income derived under broad heads.
- (iii) In the case of all concerns having works in progress, works-in-progress under broad heads.
- (iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.
(b) The aggregate, if material, of any amounts withdrawn from such reserves.
- (v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.
(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.
- (vi) Expenditure incurred on each of the following items, separately for each item:-
 - (a) Consumption of stores and spare parts.
 - (b) Power and fuel.
 - (c) Rent.
 - (d) Repairs to buildings.
 - (e) Repairs to machinery.
 - (f) Insurance.
 - (g) Rates and taxes, excluding, taxes on income.
 - (h) Miscellaneous expenses,
- (vii) (a) Dividends from subsidiary companies.
(b) Provisions for losses of subsidiary companies.
- (viii) The profit and loss account shall also contain by way of a note the following information, namely:
 - (a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –
 - I. Raw materials;

6.89 Advanced Auditing and Professional Ethics

- II. Components and spare parts;
- III. Capital goods;
- (b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;
- (c) Total value of all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;
- (d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;
- (e) Earnings in foreign exchange classified under the following heads, namely:
 - I. Export of goods calculated on F.O.B. basis;
 - II. Royalty, know-how, professional and consultation fees;
 - III. Interest and dividend;
 - IV. Other income, indicating the nature thereof

Note: Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

GENERAL INSTRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

1. Where a company is required to prepare Consolidated Financial Statements, i.e., consolidated balance sheet and consolidated statement of profit and loss, the company shall *mutatis mutandis* follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the following:
 - (i) Profit or loss attributable to "minority interest" and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.
 - (ii) "Minority interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

2. In Consolidated Financial Statements, the following shall be disclosed by way of additional information:

Name of the entity in the	Net Assets, i.e., total assets minus total liabilities		Share in profit or loss	
	As % of consolidated net assets	Amount	As % of consolidated profit or loss	Amount
1	2	3	4	5
Parent Subsidiaries Indian				
1.				
2.				
3.				
Foreign				
1.				
2.				
3.				
Minority Interests in all subsidiaries Associates (Investment as per the equity method)				
Indian				
1.				
2.				
3.				
Foreign				
1.				
2.				
3.				
Joint Ventures (as per proportionate consolidation/investment as per the equity method)				
Indian				
1.				
2.				
3.				

6.91 Advanced Auditing and Professional Ethics

Foreign				
1.				
2.				
3.				
TOTAL				

3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statements.
4. An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating.

Division II

Financial Statements for a company whose financial statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATEMENT OF A COMPANY REQUIRED TO COMPLY WITH Ind AS

1. Every company to which Indian Accounting Standards apply, shall prepare its financial statements in accordance with this Schedule or with such modification as may be required under certain circumstances.
2. Where compliance with the requirements of the Act including Indian Accounting Standards (except the option of presenting assets and liabilities in the order of liquidity as provided by the relevant Ind AS) as applicable to the companies require any change in treatment or disclosure including addition, amendment substitution or deletion in the head or sub-head or any changes inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements under this Schedule shall stand modified accordingly.
3. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Indian Accounting Standards. Additional disclosures specified in the Indian Accounting Standards shall be made in the Notes or by way of additional statement or statements unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the Notes in addition to the requirements set out in this Schedule.
4. (i) Notes shall contain information in addition to that presented in the Financial Statements and shall provide where required-
 - (a) narrative description or disaggregation of items recognised in those statements; and
 - (b) information about items that do not qualify for recognition in those statements.

(ii) Each item on the face of the Balance Sheet, Statement of Changes in Equity and Statement of Profit and Loss shall be cross-referenced to any related information in the Notes. In preparing the Financial Statements including the Notes, a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation.

5. Depending upon the turnover of the company, the figures appearing in the Financial Statements shall be rounded off as below:

Turnover	Rounding off
(i) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(ii) one hundred crore rupees or more	To the nearest, lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

6. Financial Statements shall contain the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statement including Notes except in the case of first Financial Statements laid before the company after incorporation.

7. Financial Statements shall disclose all 'material' items, i.e, the items if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size or nature of the item or a combination of both, to be judged in the particular circumstances.

8. For the purpose of this Schedule, the terms used herein shall have the same meanings assigned to them in Indian Accounting Standards.

9. Where any Act or Regulation requires specific disclosure to be made in the standalone financial statement of a company, the said disclosure shall be made in addition to those required under this Schedule.

Note: This Schedule sets out the minimum requirements for disclosure on the face of the Financial Statements, i.e, Balance Sheet, Statement of Changes in Equity for the period, the Statement of profit and Loss for the period (The term 'Statement of Profit and Loss' has the same meaning as Profit and Loss Account) and Notes. Cash flow statement shall be prepared, where applicable, in accordance with the requirement of the relevant Indian Accounting Standard.

Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance to cater to industry or sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act, 2013 or under the Indian Accounting Standards.

6.93 Advanced Auditing and Professional Ethics

PART I -BALANCE SHEET

Name of the Company.....

Balance Sheet as at

(Rupees in.....)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
(1)	ASSETS			
	Non-current assets			
	(a) Property, Plant and Equipment (b) Capital work-in-progress (c) Investment Property (d) Goodwill (e) Other Intangible assets (f) Intangible assets under development (g) Biological Assets other than bearer plants (h) Financial Assets (i) Investments (ii) Trade receivables (iii) Loans (i) Deferred tax assets (net) (j) Other non-current assets			
(2)	Current assets (a) Inventories (b) Financial Assets (i) Investments (ii) Trade receivables (iii) Cash and cash equivalents (iv) Bank balances other than(iii) above (v) Loans (vi) Others (to be specified) (c) Current Tax Assets (Net) (d) Other current assets			
	Total Assets			

	EQUITY AND LIABILITIES Equity (a) Equity Share capital (b) Other Equity			
(1)	LIABILITIES Non-current liabilities (a) Financial Liabilities (i) Borrowings (ii) Trade payables (iii) Other financial liabilities (other than those specified in item (b), to be specified) (b) Provisions (c) Deferred tax liabilities (Net) (d) Other non-current liabilities			
(2)	Current liabilities (a) Financial Liabilities (i) Borrowings (ii) Trade payables (iii) Other financial liabilities (other than those specified in item (c)) (b) Other current liabilities (c) Provisions (d) Current Tax Liabilities (Net)			
	Total Equity and Liabilities			

see accompanying notes to the financial statements

STATEMENT OF CHANGES IN EQUITY

Name of the Company.....

Statement of Changes in Equity for the period ended

A. Equity Share Capital

Balance at the beginning of the reporting period	Changes in equity share capital during the year	Balance at the end of the reporting period

6.95 Advanced Auditing and Professional Ethics

B. Other Equity	Share application on money pending allotment	Equity component of compound financial instrument	Reserve and Surplus				Debt Instrument through other Comprehensive Income	Equity Instrument through Other Comprehensive Income	Effective portion of Cash Flow Hedges	Revaluation Surplus	Exchange difference on translating the financial statement	Other items of Comprehensive Income (Specify nature)	Money received against share capital	Total
			Capital Reserve	Securities Premium Reserve	Other Reserve (Specify nature)	Retained Earnings								
	Balance at the beginning of the reporting period													
	Changes in accounting policy or prior period errors													
	Restated balance at the beginning of the reporting period													
	Total comprehensive													
	Income for the year													
	Dividends													
	Transfer to retained earnings													
	Any other change (to be specified)													

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET:

1. An entity shall classify an asset as current when-
 - (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
 - (b) it holds the asset primarily for the purpose of trading;
 - (c) it expects to realise the asset within twelve months after the reporting period; or
 - (d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

2. The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents, When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.

3. An entity shall classify a liability as current when-
 - (a) it expects to settle the liability in its normal operating cycle;
 - (b) it holds the liability primarily for the purpose of trading;
 - (c) the liability is due to be settled within twelve months after the reporting period; or
 - (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

An entity shall classify all other liabilities as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A company shall disclose the following in the Notes:

A Non-Current Assets

I. Property, Plant and Equipment :

- (i) Classification shall be given as:
 - (a) Land
 - (b) Buildings
 - (c) Plant and Equipment
 - (d) Furniture and Fixtures
 - (e) Vehicles

- (f) Office equipment
- (g) Bearer Plants
- (h) Others (specify nature)
 - (ii) Assets under lease shall be separately specified under each class of assets
 - (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

II. Investment Property:

A reconciliation of the gross and net carrying amounts of each class of property at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

III. Goodwill :

A reconciliation of the gross and net carrying amount of goodwill at the beginning and end of the reporting period showing additions, impairments, disposals and other adjustments.

IV. Other Intangible assets

- (i) Classification shall be given as:
 - (a) Brands or trademarks
 - (b) Computer software
 - (c) Mastheads and publishing titles
 - (d) Mining rights
 - (e) Copyright, patents, other intellectual property rights, services and operating rights
 - (f) Recipes, formulae, models, designs and prototypes
 - (g) Licenses and franchises
 - (h) Others (specify nature)
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses or reversals shall be disclosed separately.

V. Biological Assets other than bearer plants:

A reconciliation of the carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments shall be disclosed separately.

VI. Investment

- (i) Investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investments in Preference Shares;
 - (c) Investments in Government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms; or
 - (g) Other investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate that are-

- (i) subsidiaries,
- (ii) associates,
- (iii) joint ventures, or
- (iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). Investment in partnership firms alongwith names of the firms, their partners, total capital and the shares of each partner shall be disclosed separately.

- (ii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investment and market value thereof;
 - (b) Aggregate amount of unquoted investment: and
 - (c) Aggregate amount of impairment in value of investment.

VII. Trade Receivables:

- (i) Trade receivables shall be sub-classified as;
 - (a) Secured, considered good;
 - (b) Unsecured considered good; and
 - (c) Doubtful.

- (ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

VIII. Loans;

- (i) Loans shall be classified as-
 - (a) Security Deposits;
 - (b) Loans to related parties (giving details thereof); and
 - (c) Other loans (specify nature).

The above shall also be separately sub-classified as-

- (a) Secured, considered good;
- (b) Unsecured, considered good; and
- (c) Doubtful. Allowance for bad and doubtful loans shall be disclosed under the relevant heads separately.
- (iv) Loans due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

IX. Bank deposits with more than 12 months maturity shall be disclosed under 'Other financial assets';

X. Other non-current asset: Other non-current assets shall be classified as-

- (i) Capital Advances; and
- (ii) Advances other than capital advances;
 - (1) Advances other than capital advances shall be classified as:
 - (a) Security Deposits;
 - (b) Advances to related parties (giving details thereof; and
 - (c) Other advances (specify nature).
 - (2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated, In case advances are of the nature of a financial asset as per relevant Ind AS, these are to be disclosed under other financial assets separately.
- (iii) Others (specify nature).

B. Current Assets

I. Inventories:

- (i) Inventories shall be classified as-
 - (a) Raw materials;
 - (b) Work in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) stores and spares;
 - (f) Loose tools; and
 - (g) Others (specify nature).
- (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
- (iii) Mode of valuation shall be stated.

II. Investment;

- (i) Investments shall be classified as-
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares;
 - (c) Investment in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investment in partnership firms; and
 - (g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate that are-

- (i) subsidiaries,
- (ii) associates,
- (iii) joint ventures, or
- (iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid)

- (ii) The following shall also be disclosed
 - (a) Aggregate amount of quoted investments and market value thereof;

- (b) Aggregate amount of unquoted investments;
- (c) Aggregate amount of impairment in value of investments,

III. Trade Receivables

- (i) Trade receivables shall be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good; and
 - (c) Doubtful.:
- (ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

IV. Cash and cash equivalents:

Cash and cash equivalents shall be classified as-

- a. Balances with Banks (of the nature of cash and cash equivalents);
- b. Cheques, drafts on hand;
- c. Cash on hand; and
- d. Others (specify nature).

V. Loans;

- (i) Loans shall be classified as:
 - (a) Security deposits;
 - (b) Loans to related parties (giving details thereof); and
 - (c) others (specify nature).
- (ii) The above shall also be sub-classified as-
 - (a) Secured, considered good;
 - (b) Unsecured, considered good; and
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans shall be disclosed under the relevant heads separately.
- (iv) Loans due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies

6.103 Advanced Auditing and Professional Ethics

respectively in which any director is a partner or a director or a member shall be separately stated.

VI. Other current assets (specify nature): This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories. Other current assets shall be classified as-

- (i) Advances other than capital advances
 - (1) Advances other than capital advances shall be classified as:
 - (a) Security Deposits;
 - (b) Advances to related parties (giving details thereof);
 - (c) Other advances (specify nature)
 - (2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.
 - (a) Earmarked balances with banks (for example. for unpaid dividend) shall be separately stated.
 - (b) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
 - (c) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

D. Equity

I. Equity Share Capital: For each class of equity share capital:

- (a) the number and amount of shares authorised;
- (b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
- (c) par value per Share;
- (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
- (e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
- (f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

- (g) shares in the company held by each shareholder holding more than five per cent. shares specifying the number of shares held;
- (h) shares reserved for issue under options and contracts or commitments for the sale of shares or disinvestment, including the terms and amounts;
- (i) for the period of five years immediately preceding the date at which the Balance Sheet is prepared
 - aggregate number and class of shares allotted as fully paid up pursuant to contract without payment being received in cash;
 - aggregate number and class of shares allotted as fully paid up by way of bonus shares; and
 - aggregate number and class of shares bought back;
- (j) terms of any securities convertible into equity shares issued along with the earliest date of conversion in descending order starting from the farthest such date;
- (k) calls unpaid (showing aggregate value of calls unpaid by directors and officers);
- (l) forfeited shares (amount originally paid up).

II. Other Equity:

- (i) Other Reserves' shall be classified in the notes as-
 - (a) Capital Redemption Reserve;
 - (b) Debenture Redemption Reserve;
 - (c) Share Options Outstanding Account; and
 - (d) others- (specify the nature and purpose of each reserve and the amount in respect thereof);

(Additions and deductions since last balance sheet to be shown under each of the specified heads)
- (ii) Retained Earnings represents surplus i.e. balance of the relevant column in the Statement of Changes in Equity;
- (iii) A reserve specifically represented by earmarked investments shall disclose the fact that it is so represented;
- (iv) Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'retained earnings'. Similarly, the balance of 'Other Equity', after adjusting negative balance of retained earnings, if any, shall be shown under the head 'Other Equity' even if the resulting figure is in the negative; and
- (v) Under the sub-head 'Other Equity', disclosure shall be made for the nature and amount of each item.

E. Non-Current Liabilities

I. Borrowings:

- (i) borrowings shall be classified as-
 - (a) Bonds or debentures
 - (b) Term loans
 - (I) from banks
 - (II) from other Parties
 - (c) Deferred payment liabilities
 - (d) Deposits.
 - (e) Loans from related parties
 - (f) Long term maturities of finance lease obligations
 - (g) Liability component of compound financial instruments
 - (h) Other loans (specify nature);
- (ii) borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed;
- (iv) bonds or debentures (along with the rate of interest, and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be, where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due;
- (v) particulars of any redeemed bonds or debentures which the company has power to reissue shall be disclosed;
- (vi) terms of repayment of term loans and other loans shall be stated; and
- (vii) period and amount of default as on the balance sheet date in repayment of borrowings and interest shall be specified separately in each case.

III. Provisions: The amounts shall be classified as-

- (a) Provision for employee benefits; and
- (b) Others (specify nature).

IV. Other non-current liabilities;

- (a) Advances; and
- (b) Others (specify nature).

F. Current Liabilities

I. Borrowings:

- (i) Borrowings shall be classified as-
 - (a) Loans repayable on demand
 - (I) from banks
 - (II) from other parties
 - (b) Loans from related parties
 - (c) Deposits
 - (d) Other loans (specify nature);
- (ii) borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case;
- (iii) where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed;
- (iv) period and amount of default as on the balance sheet date in repayment of borrowings and interest, shall be specified separately in each case.

II. Other Financial Liabilities: Other Financial liabilities shall be classified as-

- (a) Current maturities of long-term debt;
- (b) Current maturities of finance lease obligations;
- (c) Interest accrued;
- (d) Unpaid dividends;
- (e) Application money received for allotment of securities to the extent refundable and interest accrued thereon;
- (f) Unpaid matured deposits and interest accrued thereon;
- (g) Unpaid matured debentures and interest accrued thereon; and
- (h) Others (specify nature).

'Long term debt is a borrowing having a period of more than twelve months at the time of origination

III. Other current liabilities:

The amounts shall be classified as-

- (a) revenue received in advance;
- (b) other advances (specify nature); and
- (c) others (specify nature);

IV. Provisions: The amounts shall be classified as-

- (i) provision for employee benefits; and
- (ii) others (specify nature)

G. The presentation of liabilities associated with group of assets classified as held for sale and non-current assets classified as held for sale shall be in accordance with the relevant Indian Accounting Standards (Ind ASs)

H. Contingent Liabilities and Commitments:

(to the extent not provided for)

(i) Contingent Liabilities shall be classified as-

- (a) claims against the company not acknowledged as debt;
- (b) guarantees excluding financial guarantees; and
- (c) other money for which the company is contingently liable.

(ii) Commitments shall be classified as-

- (a) estimated amount of contracts remaining to be executed on capital account and not provided for;
- (b) uncalled liability on shares and other investments partly paid; and
- (c) other commitments (specify nature).

I. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and title related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on irredeemable preference shares shall also be disclosed separately.

J. Where in respect of an issue of securities made for a specific purpose the whole or part of amount has not been used for the specific purpose at the Balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

7. When a company applies an accounting policy retrospectively or makes a restatement of items in the financial statements or when it reclassifies items in its financial statements, the company shall attach to the Balance Sheet, a "Balance Sheet" as at the beginning of the earliest comparative period presented.

8. Share application money pending allotment shall be classified into equity or liability in accordance with relevant Indian Accounting Standards. share application money to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable shall be separately shown under 'Other financial liabilities'.

9. Preference shares including premium received on issue, shall be classified and presented as 'Equity' or 'Liability' in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in that regard applicable to

the relevant class of equity or liability shall be applicable mutatis mutandis to the preference shares. For instance, redeemable preference shares shall be classified and presented under 'non-current liabilities' as 'borrowings' and the disclosure requirements in this regard applicable to such borrowings shall be applicable mutatis mutandis to redeemable preference shares.

10. Compound financial instruments such as convertible debentures, where split into equity and liability components, as per the requirements of the relevant Indian Accounting Standards, shall be classified and presented under the relevant heads in 'Equity' and 'Liabilities'
11. Regulatory Deferral Account Balances shall be presented in the Balance Sheet in accordance with the relevant Indian Accounting Standards.

PART II - STATEMENT OF PROFIT AND LOSS

Name of the Company.....

Statement of Profit and Loss for the period ended.....

	Particulars	Note No.	Figures as at the end of current reporting period	Figures for the previous reporting period
I	Revenue from operations			
II	Other Income			
III	Total Income (I + II)			
IV	EXPENSES			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expenses			
	Other expenses			
	Total expenses (IV)			
V	Profit/(loss) before exceptional items and tax (I-IV)			
VI	Exceptional Items			
VII	Profit/ (loss) before exceptions items and tax(V-VI)			
VIII	Tax expense:			
	(1) Current tax			

6.109 Advanced Auditing and Professional Ethics

	(2) Deferred tax			
IX	Profit (Loss) for the period from continuing operations (VII - VIII)			
X	Profit/(loss) from discontinued operations			
XI	Tax expenses of discontinued operations			
XII	Profit/(loss) from Discontinued operations (after tax) (X-XI)			
XIII	Profit/(loss) for the period (IX+XII)			
XIV	Other Comprehensive Income A. (i) Items that will not be reclassified to profit or loss (ii) Income tax relating to items that will not be reclassified to profit or loss B. (i) Items that will be reclassified to profit or loss (ii) Income tax relating to items that will be reclassified to profit or loss			
XV	Total Comprehensive Income for the period (XIII+XIV) Comprising Profit (Loss) and Other comprehensive Income for the period)			
XVI	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted			
XVII	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted			
XVIII	Earning per equity share (for discontinued & continuing operation) (1) Basic (2) Diluted			

see accompanying notes to the financial statements

GENERAL INSTRUCTIONS FOR PREPARING OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account, in like manner as they apply to a Statement of Profit and Loss,
2. The Statement of Profit and Loss shall include:
 - (1) Profit of loss for the Period;
 - (2) Other Comprehensive Income for the periodThe sum of (1) and (2) above is "Total Comprehensive Income"
3. Revenue from operations shall disclose separately in the notes
 - (a) sale of products (including Excise Duty);
 - (b) sale of services; and
 - (c) other operating revenues.
4. Finance Costs: Finance costs shall be classified as-
 - (a) interest;
 - (b) dividend on redeemable preference shares;
 - (c) exchange differences regarded as an adjustment to borrowing costs; and
 - (d) other borrowing costs (specify nature).
5. Other income: other income shall be classified as-
 - (a) interest Income;
 - (b) dividend Income; and
 - (c) other non-operating income (net of expenses directly attributable to such income)
6. Other Comprehensive Income shall be classified into-
 - (A) Items that will not be reclassified to profit or loss
 - (i) Changes in revaluation surplus;
 - (ii) Re-measurements of the defined benefit plans;
 - (iii) Equity Instruments through Other Comprehensive Income;
 - (iv) Fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss;
 - (v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and
 - (v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and
 - (vi) Others (specify nature).

6.111 Advanced Auditing and Professional Ethics

- (B) Items that will be reclassified to profit or loss;
 - (i) Exchange differences in translating the financial statements of a foreign operation;
 - (ii) Debt instruments through Other Comprehensive Income;
 - (iii) The effective portion of gains and loss on hedging instruments in a cash flow hedge;
 - (iv) Share of other comprehensive income in Associates and Joint Ventures, to the extent to be classified into profit or loss; and
 - (v) Others (specify nature)
- 7. Additional Information: A Company shall disclose by way of notes, additional information regarding aggregate expenditure and income on the following items:
 - (a) employee Benefits expense (showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) share based payments to employees, (iv) staff welfare expenses).
 - (b) depreciation and amortisation expense;
 - (c) any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 10,00,000, whichever is higher, in addition to the consideration of 'materiality' as specified in clause 7 of the General Instructions for Preparation of Financial Statements of a Company;
 - (d) interest Income;
 - (e) interest Expense
 - (f) dividend income;
 - (g) net gain or loss on sale of investments;
 - (h) net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
 - (i) payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for other services, (e) for reimbursement of expenses;
 - (j) in case of companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities; and
 - (k) details of items of exceptional nature;
- 8. Changes in Regulatory Deferral Account Balances shall be presented in the Statement of Profit and Loss in accordance with the relevant Indian Accounting Standards

PART III- GENERAL INSRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

1. Where a company is required to prepare Consolidated Financial Statements, i.e., consolidated balance sheet, consolidated statement of changes in equity and consolidated statement of profit and loss, the company shall mutatis mutandis follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet, statement of changes in equity and statement of profit and loss .In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules 2015, including the following, namely:
 - (i) Profit or loss attributable to 'non-controlling interest 'and to 'owners of the parent' in the statement of profit and loss shall be presented as allocation for the period Further, 'total comprehensive income for the period attributable to 'non-controlling interest' and to 'owners of the parent shall be presented in the statement of profit and loss as allocation for the period. The aforesaid disclosures for 'total comprehensive income shall also be made in the statement of changes in equity. In addition to the disclosure requirements in the Indian Accounting Standards, the aforesaid disclosures shall also be made in respect of 'other comprehensive Income
 - (ii) 'Non-controlling interests' in the Balance Sheet and in the Statement of Changes in Equity, within equity, shall be presented separately from the equity of the 'owners of the parent'.
 - (iii) Investments accounted for using the equity method.
2. In Consolidated Financial Statement, the following shall be disclosed by the way of additional information

Name of the entity in the Group	Net Asset i.e. total assets minus total liabilities		Share in profit or loss		Share in other comprehensive income		Share in total comprehensive income	
	As % of consolidated net assets	Amount	As % of consolidated profit or loss	Amount	As % of consolidated other comprehensive income	Amount	As % of total comprehensive income	Amount
Parent								
Subsidiaries								
Indian								
1.								
2.								
3.								
Foreign								
1.								
2.								
3.								

6.113 Advanced Auditing and Professional Ethics

Non-Controlling Interest in all subsidiaries								
Associates (Investment as per the equity method)								
Indian								
1.								
2.								
3.								
Foreign								
1.								
2.								
3.								
Joint Venture (Investment as per the equity method)								
Indian								
1.								
2.								
3.								
Foreign								
1.								
2.								
3.								
Total								

3. All subsidiaries, associates and joint venture (whether Indian or Foreign) will be covered under consolidated financial statement.

4. An entity shall disclose the list of subsidiaries or associates or joint venture which have been consolidated in the consolidated financial statement along with the reason of not consolidating.]

Liabilities of Auditors

7.1 Nature of Auditor's Liability

A member of the accounting profession, when he is in practice, offers to perform a larger variety of professional services and; he also holds himself out to the public as an accountant qualified to undertake these assignments. When, therefore, he is appointed under a statute or under an agreement to carry out some professional work it is to be presumed that he shall carry them out completely and with the care and diligence expected of a member of the profession. In view, however, of the fact that the standards of competence may vary from individual to individual and also the concept of the function of an audit and that of its technique, may from time to time undergo change, the auditor is expected to discharge his duties according to "generally accepted auditing standards" obtaining at the time when the professional work is carried out.



The implications of a professional engagement have been explained in the case *Lanphire v. Phipos* (1838) & *Case & P.* 475 cited in "Professional Negligence" by J.P.Eddy, as follows:

Fig.: Auditor's Liability*

"Every person who enters into a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill. He does not undertake, if he is an attorney, that at all events he shall gain his case, nor does a surgeon undertake that he will perform a cure; nor does he undertake to use the highest degree of skill. There may be persons who have a higher education and greater advantages than he has; but he undertakes to bring a fair, reasonable and competent degree of skill."

Either absence of the requisite skill or failure to exercise reasonable skill can give rise to an action for damage for professional negligence.

7.1.1 Taking assistance in the discharge of his duties

It is a well accepted legal principle that duties under a contract can be assigned only in cases where it does not make any difference to the person to whom the obligation is owed, which of the two persons discharges it. But contracts involving personal skill, or other personal qualifications normally cannot be assigned. It, therefore, follows that the work of an auditor being of a personal character, it must be performed either by him or by his persons under his

* Source : *NovoJuris Legal*

7.2 Advanced Auditing and Professional Ethics

supervision since he himself remains finally responsible. Only to ensure that this scheme shall be adhered to in all cases, clause (12) of Part I of First Schedule to the Chartered Accountants (Amendment) Act, 2006 makes it obligatory that reports on financial statements would be signed either by the member or his partner.

An auditor who, in the discharge of his professional obligations had relied on the report or statement of his, subsequently found to be false, cannot be held liable in a criminal action brought against him (*Rex. v. Hinds Musgrave Stevens*).

This is, however, no bar to assistance being taken in the performance of a duty or engagement. It is, therefore, quite common for the auditors to engage persons some of whom are professionally qualified, while others are not, to assist them in their work. The principals, however, are expected to guide and supervise their work and are personally responsible for any dereliction of duty or absence of care or skill in performance of an audit or any other professional engagement. They cannot ordinarily shift any part of this liability to their employees.

Such legal position is clearly borne by the following extracts from the judgements in two celebrated cases:

- (1) In *Henry Squire (Cash Chemists) Ltd. v. Ball Baker & Co.*: "The principal must not excuse himself for his clerk's negligence by saying that he employed a clerk."
- (2) In the *Superintendent of Police v. M. Rajamany*: "No auditor can escape from personal liability by taking shelter under the misconduct of his own employees."

The decision in the *Rajamany's* case also places a limitation on the extent to which an auditor may delegate his duties to his assistants:

"Callowness and irresponsible abdication of his (auditor's) work can never be regarded as anything but misconduct. An auditor who does not personally look into the accounts but merely delegated it to his assistants cannot be said to be acting with due skill and care."

Despite the fact the principal is responsible for the misdemeanor and misdeeds of his employees, in order that such of them as are qualified may discharge their duties, which are assigned to them with adequate skill and care, the Council has issued the following Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008 in the exercise of powers vested in it by Chapter II:

"In exercise of the powers conferred by Chapter II of Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties."

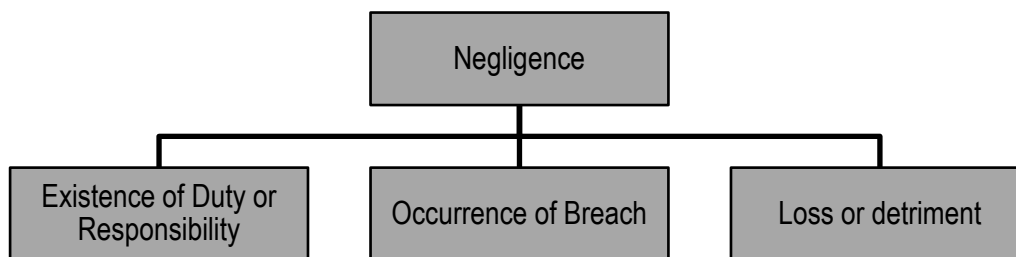
In the absence of this clause, only the Chartered Accountant who had signed the report would be liable and it would not be possible to reach the employee chartered accountant on grounds of misconduct. The above Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008 safeguards the interest of members who engage Chartered Accountants and issue reports on the basis of the work carried on by them.

7.1.2 Basis of liability

The liability for professional negligence may arise either under a statute or an agreement; the liability may be civil or criminal, disciplinary action for professional misconduct under section 21 of the Chartered Accountants Act can also be taken against a Chartered Accountant for failure to discharge his professional duties competently or diligently.

7.2 Professional Negligence

Negligence, which is culpable, generally consists of undermentioned three elements:



- (a) existence of duty or responsibility owed by one party to another to perform some act with certain degree of care and competence;
- (b) occurrence of a breach of such duty; and
- (c) loss or detriment, being suffered by the party to whom the duty was owed as a result of negligence.

In this context, professional negligence would constitute failure to perform duties according to “accepted professional standards”, resulting in some loss or damage to a party to whom the duty is owed.

(A) To whom is the duty owed?

A professional man is deemed to have been negligent only when he owed a duty to a person or persons and he had failed to perform or had performed it negligently. If a loss had been suffered by a client through the action of the auditor, his liability would be determined on the basis of the contract of engagement according to which the auditor had undertaken to provide service. When a loss has been suffered by a third party who is not privy to the arrangement between the clients and the auditor for determining whether he is liable, it is necessary to find out whether the auditor owed any duty to him. This will be apparent from the summary of legal decisions discussed hereinafter.

The financial statements, on which the auditors report, are designed to serve the needs of a variety of users, particularly owners and creditors. There are users who have direct economic interest in the concerned business enterprise like the owners, creditors and suppliers, potential owners, management, taxation authorities, employees and customers. There are also others who have indirect interests like financial analysts and advisers, stock exchanges, lawyers, regulatory authorities, financial press, trade associations and labour unions. Usually, these parties are not in priority with the auditor. Under what circumstances these parties not in priority

7.4 Advanced Auditing and Professional Ethics

should with the auditor be allowed to recover from the auditor losses that they incur as a result of the auditor's dereliction of duty? The solution seems difficult. To hold a negligent auditor liable "in an indeterminate amount for an indeterminate time to an indeterminate class" will be stretching the limit too far. We cannot at the same time brush aside the whole concept of auditors' liability to those parties with whom he has no privity of contract. If responsibility is to be imposed where specific users are identified, then to what extent will it be imposed and what criteria will be used to determine the specific user to whom the auditor should be responsible? Liability imposed should have some relation to the responsibility reasonably assumed and the fees charged.

The evolution of law in this regard varies widely in England and the United States. So far as our country is concerned, we should say that much headway has not been made. Hence, it will be highly instructive to analyse the situation under the following three heads:

- (1) English Scene.
- (2) American Scene.
- (3) Indian Scene.

English scene: The general rule in England is that only parties to a contract may enforce the rights under the contract.

In *Derry v. Peek* (1889) 14 A. C 337, it was held that there is no liability to third parties for negligent language that resulted only in pecuniary loss, although liability to third parties could be established if the negligent misrepresentation resulted in loss of life, limb or health. It was held that a false statement made through carelessness and without reasonable ground for believing it to be true could be evidence of fraud. However, if it was made in the honest belief that it was true, it was not fraudulent and could not render the person liable in deceit. However, this decision was the subject of great controversy.

English courts continued to follow *Derry v. Peek* until 1963. During this period there was no liability to third parties for negligent misrepresentation except when a special duty to be careful was imposed by contract a fiduciary relationship or likelihood of physical damage to person or property.

Direct case on an Accountant's liability to third parties: The question of Accountant's liability to third parties directly came up for consideration in England in the case of *Candler v. Crane Christmas & Co.* The fact to the case were that a firm of accountants had been engaged by a company to prepare the company's accounts. The accountants knew that the statements of account would be shown to third parties. Relying on the statements of account reported upon by the accountants, the plaintiff had invested money in the company and it was lost. The statements in question had been prepared negligently but there was no fraud. *Cohen and Asquith L.J.* (Denning, L.J. dissenting), held that a false statement made carelessly, as contrasted with one fraudulently made by one person to another, though acted on by that other to his detriment was not action in the able absence of any contractual or fiduciary relationship between the parties Lord Denning, however, dissented, and said:

"..... the Accountant, who certifies the accounts of his client is always called upon to

express his personal opinion whether the accounts exhibit a true and correct view of his client's affairs; and he is required to do this not so much for the satisfaction of his own client but more for the guidance of shareholders, investors, revenue authorities, and others who may have to rely on the accounts in serious matters of business. If we should decide this case in favour of the Accountants there will be no reason why Accountants should ever verify the word of the man in a one man company, because there will be no one to complain about it. The one man who gives them wrong information will not complain if they do not verify it. He wanted their backing for misleading information he gives them and he can only get it if they accept his word without verification. It is just what he wants so as to gain his own ends. And the persons who are misled cannot complain because the accountants owe no duty to them. If such be the law, I think it is to be regretted, for it means that the accountant's certificate which should be a safeguard, becomes a share for those who rely on it. I do not myself think it is the law. In my opinion Accountants owe a duty of care not only to their own clients; but also to those who they know will rely on their accounts in the transactions for which these accounts are prepared."

A turning point: *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1963) All E.R. 575: (1964). 1 Camp L.J., 14, the House of Lords. In the case, the subject of liability to third parties for negligence of a professional person has been comprehensively reviewed. The House of Lords unanimously overruled the majority decision in *Candler v. Crane, Christmas & Co.* and upheld Lord Denning's dissenting opinion in that case. Though the *Hedley Byrne* case did not directly concern an Accountant, the principle laid down in the case is applicable to Accountants.

However, for recent cases have suggested a break away from the *Hedley Byrne* 'special relationship principle.' *Jeb Fasteners* - In 1975, Marks, Bloom and Co., the defending firm of auditor reported on the annual financial statements of B.G. fasteners Ltd. for the year ended 31 October, 1974. Stock had been valued at net realisable value of £2. instead of at cost of £11,000 resulting in overstated income and balance sheet figure. The auditors were aware of the company's liquidity problems, and had discussions with *Jeb Fasteners*, the plaintiffs, at the time of takeover negotiations.

Jeb Fasteners subsequently purchased the company, but the takeover was not a success. Consequently, *Jeb* sued the auditors on the grounds that they were made into purchasing the company by the mis-stated financial statement, and that the auditors had a duty of care to persons whom they could have reasonably foreseen would rely on their audit report. Justice Woolf ruled that such a duty of care did exist, but the auditors escaped liability on the grounds that the alleged negligence was not the cause of the loss. The judge ruled that the primary purpose of the takeover appeared to be the acquisition of the services of the two B.G. directors, and that a purchase would probably have taken place on the same basis even had the true financial position been known.

Justice Woolf applied a 'reasonable foresight' test, as opposed to the 'special relationship test of *Hedley Byrne*. This was based on a judgement by Lord Woolf force in the 1977 case of *Anns v. London Borough of Merton*, in which it was held that: 'First, one has to ask whether, as between the alleged wrongdoer and person who has suffered damage there is a sufficient relationship of neighbourhood such that, in the reasonable contemplation of the former,

7.6 Advanced Auditing and Professional Ethics

carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises.

'Second, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negate, or reduce or limit the scope of the duty of the class of person to whom it is owed or the danger to which any breach of it may give rise.'

In *Jeb Fasteners*, Justice Woolf ruled that the auditors were aware of the liquidity problems of B.G. and that financial assistance would become necessary and that a takeover was certainly one method which, was within the contemplation of Mr. Marks (the auditor). Consequently, the judge decided that the events leading to the takeover of B.G. were foreseeable, although it agreed by all parties that at the time of the audit Marks, Bloom and Co. were not aware of reliance by the plaintiffs or even of the fact that a takeover was contemplated.

The Court of Appeal agreed that there was a lack of causal connection between the auditor's negligence and *Jeb's* loss. It further stated that it was not necessary for it to decide on the extent of liability to confirm in favour of the defendant.

Accordingly, Justice Woolf's ruling has some authority but leaves the extent of third party liability still unconfirmed.

A usual argument against the extension of liability to third parties is that company law requires the auditor to report to the existing shareholders, for the purposes of stewardship only. And that the accounts have not necessarily been prepared with others in mind. This latter is not a powerful argument, for it is hard to imagine a situation where accounts which are true and fair to members will be sufficiently misleading to others to provide the basis of a claim for negligence. Financial loss to creditors or other third parties will normally only occur as a result of the auditor's default, if the auditors have made some very significant 'goof.' And auditors, insurers should be well able to cover this risk, which could otherwise unfairly result in individuals bearing the loss.

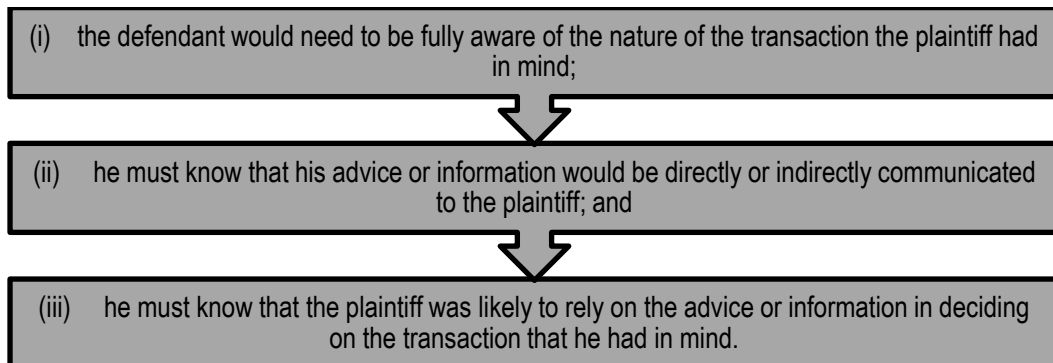
On the other hand, it can be strongly argued that if the company law wants auditors to report to creditors, and others, it should clearly say so. And tort should not be used as a backdoor approach for creating such a liability; although on grounds of equity one can question whether the auditor should in fact be held responsible for the financial loss of every potential investor and every creditor who seeks to rely on his report. In the words of Cardozo in the famous American case of the *Ultramares Corporation v. Touche*, "..... it would be wrong for accountants to be exposed 'to liability in an indeterminate amount for an indeterminate time to an indeterminate class'. The amounts involved could indeed be almost infinite, and the fact of reliance very difficult to prove projectively (herein would lie the auditors' the greatest safeguard). Furthermore, it is the directors who should really take primary responsibility for loss through misleading accounts. Yes so often they are 'men of straw' so there is no point in pursuing them; the auditors, with their insurance cover, will prove a much better bet. But should we have to entirely bear this heavy burden, via our insurance premiums, whereas directors can often escape with a suspended jail sentence and their illgotten spoils? Perhaps directors should also carry a mandatory indemnity insurance, as a requirement of holding office.

CAPARO Industries V. Touche Ross - M/s. Touche Ross, a firm of accountants had appealed to the House of Lords from a decision of the Court of Appeal which held that auditors could be

sued by an investing shareholder for inaccuracy in accounts or misleading accounts by which a pre-tax profit should have been shown as a loss. On the facts, it was alleged that CAPARO would not have bid for the takeover of Fidelity, a public company, if the true accounts were known.

The House of Lords opined that in advising his clients, the professional owed a duty to exercise the standard of skill and care appropriate to his professional status. He would be liable to contract and tort for losses his client might suffer from breach of the duty. The House of Lords observed that where a statement was put into general circulation and might forcibly be relied on by strangers for anyone of a variety of different purposes which the makers of the statement had no specific reason to anticipate, the duty to use care did not exist. The auditors owed no duty of care to the members of the public who relied on the accounts in deciding to buy shares. It was difficult to visualise a situation in which individual shareholders could claim to have sustained loss in respect of existing shareholdings referable to auditors' negligence which could not be recouped by the company. A purchaser of additional shares stood in the public to whom the auditors owed no duty. It was also held that the purpose of the auditor's certificate was to provide those entitled to the report within information to enable them to exercise their proprietary powers. It was not for individual speculation with a view to profit. The purpose of annual accounts so far as members are concerned, was to enable them to question past management, to exercise voting rights and to influence future policy management.

The learned judges disclosed that for a duty to exist the following conditions must be satisfied:



It is interesting to note that Touche Ross, the auditors in the case, made an out of court settlement with Caparo of £1.35m in July, 1994 to avoid any further legal action. They denied any negligence, a position they have maintained throughout the case.

In *Al Saudi Bank and others v Clark Pixley and another* (1990), the Caparo principles were applied and, because the auditor had not directly sent a copy of the audited statements to a bank about to grant a loan to his client, and had not been aware that the statements had been distributed, the relationship to the client was not deemed to be sufficiently close. The fact that a potential lender could foreseeably come to possess statements was not enough to create the necessary relationship.

Subsequent to the Caparo case, three more cases have endorsed its doctrine. They are *James Mc Naughton Paper Group Ltd v Hicks Anderson and Co* (1991), where a duty of care was

7.8 Advanced Auditing and Professional Ethics

denied again because, it applied to shareholders as a class not as individuals; Berg Sons and Co and others v, Adams and others (1992), which showed that the auditor's work had been performed only to satisfy the statutory audit requirement and no more, and could not support a duty of care to a finance house that had discounted Berg's bills; and Goloo and others v Bright Grahame and Murray (1993) which would not extend the classes of persons to whom the accountant might be liable and which reinforced the view that it must be proved that an auditor's negligence must be the "effective and dominant cause" of loss for a liability to exist.

Clearly these recent cases have upheld the principles established in the Caparo judgement.

Only one case, Morgan Crucible Co PLC v Hill Samuel and Co Ltd (1991) has threatened to dilute the effects of the Caparo decision. The facts of the case were that company taking over another, relying on information provided by the auditor of the target company, as in Caparo. Since the directors of the target company circularised all their shareholders forecasting a sizeable increase in pre-tax profits, supported by a letter from the auditors and the auditors' opinion was issued after the takeover had commenced, and thus the plaintiff was not relying solely on the accounts but also on these further representations. Thus, it was held the auditor had a duty of care in that, whereas in the Caparo case the audited accounts had been drafted for one purpose but had been relied upon for a different purpose, in this case, the opinion had been relied upon for the purpose for which it was issued. The degree of proximity was such that the defendant could well be liable. The case was settled out of court. Similarly, in Columbia Coffee and Tea Party Ltd v. Churchill and others (1992), the Court held that a third party investor was owed a duty of care on the basis of an assumption of responsibility flowing from statements in the defendant's auditor manual which brought a potential purchaser of shares within the ambit of persons to whom a duty of care was owed. In Possfund v. Diamond (1996), it is being argued that a duty of care is assumed and owed to these investors who (as intended) rely on the contents of the prospectus in making subsequent purchases.

American Scene: The common law liability of the auditor to third parties is important in any discussion of the auditor's legal liability. A third party may be defined as an individual who is not in privity with the parties to a contract. From a legal stand-point, there are two classes of third parties: (1) a primary beneficiary and (2) other beneficiaries, A primary beneficiary is anyone identified to the auditor by name prior to the audit who is to be the primary recipient of the auditor's report. For example, if at the time the engagement letter is signed, the client informs the auditor that the report is to be used to obtain a loan at the city national bank, the bank becomes a primary beneficiary. In contrast, other beneficiaries are unnamed third parties, such as creditors, stockholders, and potential investors.

The auditor is liable to all third parties for gross negligence and fraud under tort law. In contrast, the auditor's liability for ordinary negligence has traditionally been different between the two classes of third parties.

Liability to Primary Beneficiaries - The privity of contract doctrine extends to the primary beneficiary of the auditor's work. The landmark case, Ultramares Corp. v. Touche (now deloitte and Touche), and its major findings are as follows.

In essence, Ultramares upheld the privity of contract doctrine under which third parties cannot sue auditors for ordinary negligence. However, judge Cardozo's decision extended to primary

beneficiaries the rights of one in privity of contract. Hence, Ultramares as a primary beneficiary could sue and recover for losses suffered because of the auditor's ordinary negligence.

The defendant auditors, Touch, failed to discover fictitious transactions that overstated assets and stockholders equity by \$700,000 in the audit of Fred Stern & Co. On receiving the audited financial statements, Ultramares loaned Stern large sums of money that Stern was unable to repay because it was actually insolvent. Ultramares sued the CPA firm for negligence and fraud.

The court found the auditors guilty of negligence but ruled that accountants should not be liable to any third party for negligence except to a primary beneficiary.

An analysis of the decision reveals several significant environmental factors that are particularly interesting in view of the current legal environment. First, the judge recognized that extending liability for ordinary negligence to any third part might discourage individuals from entering the accounting profession, thus depriving society of a valuable service. Second, he feared the impact that a broader encroachment on the privity doctrine might have on other professionals such as lawyers and doctors. Third, the decision reaffirmed the auditor's liability to any third party for gross negligence or fraud.

Liability to Other Beneficiaries - The Ultramares decision remained virtually unchallenged for 37 years, and it still is followed today in many jurisdictions. However, since 1968, several court decisions have served to extend the auditor's liability for ordinary negligence beyond the privity of contract doctrine.

A Foreseen Class: The first shift away from Ultramares occurred in the form of judicial acceptance of the specifically foreseen class concept. This concept is explained as follow:

If the client informs the CPA that the audit report is to be used to obtain a bank loan, all banks are foreseen parties, but trade creditors and potential stockholders would not be part of the foreseen class. The liability is limited to losses suffered through reliance on the information in a transaction known by the auditor or a similar transaction. In the above instance, this means that the accountant would not be liable if the audit report was used by a bank to invest capital in the client's business in exchange for common stock instead of granting a loan.

The foreseen class concept does not extend to all present and future investors, stockholders, or creditors. Court decisions have not required that the injured party be specifically identified, but the class of persons to which the party belonged had to be limited and known at the time the auditor provided the information.

Foreseeable Parties: Individuals or entities whom the auditor either knew or should have known would rely on the audit report in making business and investment decisions are foreseeable parties. This concept extends the auditor's duty of due care to any foreseeable party who suffers a pecuniary loss from relying on the auditor's representation. Foreseeable parties include all creditors', Stock holders and present and future investors. Foreseeability is used extensively by the courts in cases involving physical injury. For example, foreseeability is almost universally used in product liability cases when the manufacturer's negligence causes the physical injury. This concept was first applied in an audit negligence case in the early 1980s. *Rusch Factors Inc v. Levin* (1968)

7.10 Advanced Auditing and Professional Ethics

Cases Illustrating Liability to Other Beneficiaries: The leading cases that extended the accountant's liability for ordinary negligence to foreseen parties and to foreseeable parties are as follows:

In *Rush Factors Inc. vs. Levin* (1968), the plaintiff had asked the defendant accountant to audit the financial statements of a corporation seeking a loan. The certified statements indicated that the potential borrower was solvent when, in fact, it was insolvent. Rush Factors sued the auditor for damages resulting from its reliance on negligent and fraudulent misrepresentations in the financial statements. The defendant asked for dismissal on the basis of lack of privity of contract.

The court ruled in favour of the plaintiff. While the decision could have been decided on the basis of the primary benefit rule set forth in *ultramares*, the court instead said.

The accountant should be liable in negligence for careless financial misrepresentation relied upon by actually foreseen and limited classes of persons. In this case, the defendant knew that his certification was to be used for potential financial of the corporation (emphasis added).

The Indian Scene: Commissioner of Income Tax v. G.M. Dandekar: This is the only decision on the auditor's liability to a third party by an Indian Court. The facts of the case are: Mr. Dandekar had been engaged by Messrs A. Mohamad & Co., Madras and had prepared the statements of account and Income-tax Return on the basis of account produced to him. During the course of assessment, it was discovered that Messrs. Mohamad & Co. had maintained two sets of account-regular Day Books and ledgers for the open market transactions and a separate book for the black market transactions. While the former contained detailed entries, relative to daily transactions, the latter contained only consolidated entries, made at the end of the week of the transactions of that week. At the end of the financial year, all the weekly entries in the separate sets of books of account were to called up and were entered in the regular books of account. Mr. Dandekar had examined only the regular books of account of the assessee and prepared the statements of account and the Income-tax Return on the basis of these units. All the statements were signed by him and there was also endorsement at the foot of the Balance Sheet that it had been verified and found to be correct. Mr. Dandekar had forwarded the statements of account to the Income-Tax Officer and, while doing so had stated particulars of books of account that he had examined.

On examination, the statements of account having been found to be wrong, the Income-tax department took up the matter against Mr. Dandekar and filed a complaint with the Institute of Chartered Accountants of India. When the matter was subsequently considered by the Madras High Court it was held that "he (Mr. Dandekar) was under an obligation to perform auditing with due skill and diligence; if he did that; it would be difficult to see what further obligations he had in the matter and in the favour of whom. The Accountant is under a duty to prepare and resend correct statements of account of the assessee and he should, of course, neither suggest or assist in the preparations of false accounts. But, he is under no duty to investigate whether the accounts prepared by the assesses are correct or not. The charge is that he owed a duty to the Department to himself investigate the truth and correctness of the accounts of the assessee and not merely to act as their Post Office in transmitting them. We do not agree that the respondent is under any such duty to the Department and, therefore, no question of negligence arises."

In view of the English decision (Hedley Byrne's Case) mentioned earlier, the decision in this case may any more be considered to be good law. For, very likely, the Indian Courts may hereafter follow the decision in the Hedley Byrne case and hold that the auditor is responsible to all those persons for negligence who had relied on a financial accounts or statement prepared by him which is incorrect, if he knows or ought to have known that it has been prepared for a particular person or class of persons or may be relied on by the person, or class of persons in that particular connection.

The effect of the Hedley Byrne decision is that someone possessed of a special skill may, quite irrespective of a contract, be considered to have undertaken to apply that skill for the assistance of another person and thereby to have accepted a duty of care to that person. A negligent though honest, misrepresentation which causes financial loss to another may thus, in certain circumstances, give rise to an action for damages at the suit of a person with whom no contract exists.

This doctrine is of particular concern to practising accountants, an important part of whose work consists of preparing, examining or expressing an opinion on financial statements of various kinds which may be relied on by persons other than those for whom they were originally intended; the implications should not be overlooked by any accountant who knows that his professional skill, exercised in an independent capacity, whether gratuitously or not, will be relied on by others.

(B) Breach of Duty or Negligence: To charge a professional man with breach of duty or negligence, it is necessary to prove that there has been a deviation from the standard of care which he was expected to exercise in the performance of his duties. A professional man does not guarantee the success of his professional effort. Nevertheless he is expected to possess a certain amount of knowledge and experience and he must exercise a reasonable degree of care and skill for the performance of duties. If there is any default or failure in the conduct of an audit or in carrying out any other engagement judged by professional standards the person responsible, therefore, would be guilty of negligence.

The auditor being an expert, skilled in the techniques of accounting and auditing, is expected that he would be in possession of certain standards of knowledge and experience. He also must exercise the same degree of prudence, skill and care, as any other professional person, in similar circumstances, would be expected to do. In other words, he must carry out the audit according to 'accepted professional standards' (the implications of these words are explained hereafter) and having regard to all facts known to him about the financial solvency of the client.

The auditor, however, is not expected to be a detective nor is he required to approach his work with a suspicious or pre-conceived notion that there is something wrong. He is a watch dog but not a 'blood hound'. However, if there is any thing that excites suspicion in him, he should delve deep into the matter. But, in the absence thereof, he is only required to be reasonably cautious and careful.

In the case of non-company audit, where a detailed audit is not required the scope and extent of routine checking that must be carried out is determined, on a consideration of the nature of engagement. Nevertheless, it is expected that the auditor would carry out the checking of accounts and verification of statements according to 'standards on auditing'. For example, the

7.12 Advanced Auditing and Professional Ethics

auditor who verifies the books of account of client by the application of test checks, in a case where a complete audit should have been carried out, would be held guilty of professional negligence if subsequently it is found that a mistake or fraud had remained undetected which would have been unearthed if a detailed audit had been carried out. On this account, where a detailed audit has been carried out, on the ground that it was not agreed upon, the fact should be brought to the notice of the client by the nature of checking carried out being stated in the report and area of accounts which have been covered being specified.

Likewise, under the general principles of law, the auditors have been called upon to pay compensation to their clients for the losses suffered by them through their negligence. Only in one case, i.e. *Armitage v. Brewer and Knott*, the auditors were held responsible for the amount of defalcations which arose subsequent to their failure to detect frauds in an earlier period.

7.3 Cases Concerning the Civil Liability of Auditors for Negligence

In the series of cases considered below, action was brought against the auditors for damages sustained through defalcation of employees or otherwise which, it has been alleged would have been discovered by the auditors, if they had carried out their duties with the required degree of care and skill. The plaintiffs in some cases were individuals or partners and directors in the other companies but action was not brought under misfeasance proceedings of the Companies Act. It may be observed that in general the defence was that the frauds were such that reasonable diligence and careful audit would have failed to reveal them or they were caused by lack of efficiency of the management, or in its supervision over the accounts.

1. *London Oil Storage Co. v. Seear Hasulk & Co.* (1904): In this case, the auditors were charged with negligence for failure to discover the misappropriation of the petty cash balance, which was shown by the petty cash book at 799 but in fact was only 30. The auditor was found guilty of negligence in not verifying the petty cash balance as part of the audit; but the damages awarded were limited to £5.5 sh. on the ground that the damages suffered were not due to the conduct of the auditor but that of directors who were guilty of gross negligence in allowing the balance in the hands of the Petty Cashier to increase to such a large amount.

2. *Arthur E. Green & Co. v. The Central Advance and Discount Co. Ltd.* (1901): The auditors in this case had accepted the schedule of bad debts supplied to them by the Managing Director although it was inaccurate and they were far from satisfied with it. Despite the fact, they had failed to qualify their report. The claim filed by the liquidator of the company against the auditors for negligence therefore, succeeded.

3. *Pendleburys Ltd. v. Eills Green & Co.* (1936): The charge in this case was that due to failure on the part of the auditor to verify the amount recorded and received for cash sales, the fraud of the cashier had not been discovered. But the charge did not succeed since the auditors have repeatedly brought the lack of internal check on 'cash receipts to the attention of the three directors who were the only shareholders and debenture holders of the company. In the course of judgement, the learned judge observed:

“He (the auditor) is there to see that the shareholders get a true representation of the finances of the company as disclosed by its books, this he must do with reasonable care, but in considering whether or not he has displayed reasonable care one must apply rules

of common sense. There is all the world of difference between a company which has a large body of shareholders numbering say, six or seven hundred and a company which has only three shareholders; all of whom happen to be the sole directors and the sole debenture holders..... Where the interests of a small company are confined to a very few persons and there are no outside people because all the interests in the company are held by the directors themselves, if the auditor has, in fact, reported to the directors, what more could he be expected to do?"

4. *Leads Estate and Investment Society Ltd. v. Shepherd* (1887): In this case action was brought by the liquidators against the auditors not under misfeasance proceedings, but under a civil action for the recovery for amounts paid as dividend out of capital. In examining the balance sheet, the auditor had not considered the provision in the Articles and the balance sheet was not properly drawn up. In the course of the judgement, the learned judge observed that it was the duty of the auditor in auditing the accounts of the company not to confine himself to verifying the arithmetical accuracy of the balance sheet, but to enquire into its substantial accuracy, and to ascertain that it contained the particulars specified in the Articles of Association, and was properly drawn up so as to contain a true and correct representation of the company's affairs. The auditor was found negligent by the Court.

5. *Armitage v. Brewer & Knot* (1942) ACTC (P 836): In this case, action was brought by Mr. Joseph Armitage for alleged negligence in auditing the plaintiff's books by reason of which defalcations aggregating to £1440 were not detected. The defalcations consisted in fraudulent alterations of time sheets and petty cash vouchers.

The plaintiff had arranged with the auditor that they would vouch all payments with the receipts entered in the Petty Cash Account, check calculations and additions of wages sheets, check totals of wages sheets into wages book and check weekly totals with other detailed provisions.

Such a detailed audit had been called for since the plaintiff wanted protection against his staff. A special fee was demanded and paid for this work. But it transpired after the audit had been in progress for some two and half years, that the cashier of the plaintiff, by altering systematically figures on vouchers of petty cash and making fraudulent entries on time sheets, had misappropriated a large sum of money. During the course of the hearing, it transpired that the auditors had not examined the books of account with sufficient care as a result whereof the frauds committed by the cashier had remained undetected. Mr. Justice Talbot, during the course of his judgement, observed that "Accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was small matter." The auditors were held guilty of negligence and a damage of £1259 was awarded against them.

6. *Tri-Sure India Ltd. v. A.F. Ferguson & Co.*: Tri-Sure India Limited issued a prospectus of February 75 inviting public to subscribe its share. The prospectus contained, inter alia, the report of the auditors (the defendants) on the accounts of the company for the year 1973-74 which showed that there was an abnormal rise in the rate of profits for the year 1973-74. The public issue was over-subscribed and the company proceeded to allot the shares as per the term of the issue. An investigation later revealed that sales figures for 1973-74 had been manipulated by a whole time director of the company with the active co-operation of other top officials of the company. On discovery of this, the company offered to refund all moneys which were subscribed

7.14 Advanced Auditing and Professional Ethics

by the allottees and also proceeded to sue the auditors for damages of ₹ 63.85 lakhs. The company alleged that the auditors failed to examine and ascertain any satisfactory explanation for steep increase in the rate of gross and net profits. The other charges levelled against the auditors were (i) whether the consumption of raw material was commensurate with the sharp increase in sales/production; (ii) the reasons for disproportionate ratio of the total debts due by trade debtors to turnover as compared to the previous years; (iii) the reason for material variation in the ratio of the value of stock on hand to the cost of turnover for the year 1972-73 and for the year 1973-74; (iv) whether there was any change in the prices of prime raw material; (v) whether there was any improvement/deterioration in the usage of material; (vi) whether the company had got new customers and/or there was any change in the terms of credit to customers; and (vii) whether the production for the year was adequate to support the volume of sales and closing stock for the year.

The Court held that the plaintiffs were not able to prove that the auditors were negligent in the performance of their duties. The suit was, therefore, dismissed.

Regarding the duties of the auditor, the Court held that “the auditor is required to employ reasonable skill and care, but he is not required to begin with suspicion and to proceed in the manner of trying to detect a fraud or a lie, unless some information has reached which excites suspicion or ought to excite suspicion in a professional man of reasonable competence. An auditor’s duty is to see what the state of the company’s affairs actually is, and whether it is reflected truly in the accounts of the company, upon which the balance sheet and the profit and loss account are based, but he is not required to perform the functions of a detective. What is reasonable care and skill must depend upon the circumstances of each case. Where there is nothing to excite suspicion and there is an atmosphere of complete confidence, based on the record of continued success in financial matters, less care and less scrutiny may be considered reasonable.” Thus, the judgment has re-emphasised that an auditor need not proceed with suspicion unless the circumstances are such as to arouse suspicion or ought to arouse suspicion in a professional man of reasonable competence. The practice of resorting to selective verification where internal controls are found to be satisfactory by an auditor has also been upheld in his judgement.

7.4 Civil Liabilities under the Companies Act

A civil action against the auditor may either take the form of claim for damages on account of negligence or that of misfeasance proceeding for breach of trust or duty:

(I) Damages for negligence: Civil liability for mis-statement in prospectus under section 35 of the Companies Act, 2013, are:

(1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—

- (a) is a director of the company at the time of the issue of the prospectus;
- (b) has authorized himself to be named and is named in the prospectus as a director of the company or has agreed to become such director either immediately or after an interval of time;

- (c) is a promoter of the company;
- (d) has authorised the issue of the prospectus; and
- (e) is an expert referred to in sub-section (5) of section 26,
shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.
- (2) No person shall be liable under sub-section (1), if he proves—
- (a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or
- (b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.
- (3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

It may be noted that the term “expert” as defined in Section 2(38) of the Companies Act, 2013 includes an engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power or authority to issue a certificate in pursuance of any law for the time being in force. Also that under Section 26 of the Act a statement may be considered to be untrue, not only because it is so but also if it is misleading in the form and context in which it is included.

The liability would arise if the written consent of the auditor to the issue of the prospectus, including the report purporting to have been made by him as an “expert” has been obtained.

(II) **Liability for misfeasance:** The term “misfeasance” implies a breach of trust or duty. The auditor of a company would be guilty of misfeasance if he has been guilty of any breach of trust or negligence in the performance of his duties which has resulted in some loss or damage to the company or its property.

A few cases in which action has been brought against the auditors under misfeasance provisions of the Companies Act are summarised below:

1. In *Re: The London and General Bank, (1895)*, held - The auditor who does not report, to the shareholders the facts of the case, when the balance sheet is not properly drawn up, is guilty of misfeasance.

The charge against the auditor in this case was that though he had submitted a detailed report to the directors, as regards loans and overdrafts granted to customers, in respect of which the security lodged was wholly insufficient and had expressed his misgivings as regards recovery of interest on these accounts, included in the Profit and Loss Account, he had neither disclosed

7.16 Advanced Auditing and Professional Ethics

the position to the shareholders nor he had made any reference to the report which he had laid before the directors. The words in his report, "the value of assets as shown on the Balance Sheet is dependent upon realisation etc." did not contain any warning to shareholders and the mere presence of these words was not enough to excite suspicion. The Court observed that the duty of the auditor was to convey information and not to arouse enquiry and held that the auditor, by way of damages, was liable to refund the amount of the second dividend (declared in 1892) on the ground that he was aware of the critical position of the affairs and thus had acted negligently in not reporting the facts to the shareholders although he had reported them to directors. As regards the first dividend (declared in 1891), the auditor was not held liable, as it was of the opinion that the evidence was not sufficiently strong to establish a case of misfeasance against him, though he was guilty of an error of judgement.

2. In *Re: Kingston Cotton Mills Co. Ltd.* (1896), held - That it is not the duty of the auditor to take stock and that he is not guilty of negligence if the certificate of a responsible official is accepted in the absence of suspicious circumstances.

In this case, the profits of the company had been inflated fictitiously by the deliberate manipulation of the quantities and values of stock-in-trade. The auditors had certified the balance sheet on the basis of the certificate of the manager as to the correctness of the stock-in-trade without checking the stock in detail and this fact was shown on the fact of the balance sheet. Lopes L.J. exonerating the auditors of the charge of negligence, in the course of judgement, made remarks to the following effect:

It is the duty of an auditor to bring to bear on the work, he has to perform the skill, care and caution which a reasonably competent, careful and cautious auditor ordinarily would use. What is reasonable skill, care and caution is a matter which must be judged on consideration of the special circumstances of each case. An auditor is not bound to act as a detective, or as had been said to approach his work with suspicion or with a foregone conclusion that there is something wrong. 'He is a watch dog, but not a blood hound'. He is entitled to rely on the representation made to him by the tried servants of the company in whom confidence has been placed by the company, believing them to be honest and truthful. He must, however, take reasonable care to find that the representations made by them are not palpably false. If any matter is observed which is calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonable, cautious and careful.

3. *The Irish Woolen Co. Limited v. Tyson and others* (1900) Act L.R. 23, held - That an auditor is liable for any damages sustained by a company by reasons of falsification of accounts which might have been discovered by the exercise of reasonable care and skill in the performance of the audit.

In this case, under a special agreement with the company, the auditor was required to conduct a monthly audit, despite the fact, the profit disclosed by the profit & loss account was found to have been inflated by the suppression of certain purchase invoices outstanding at the date of the balance sheet though the goods received in respect thereof had been included in the closing stock. The learned judge hearing the case found that the suppression of invoices would have been detected if the auditor had called for the creditors' statements of account on the basis of which payment had been ordered, in the period subsequent to the audit, and had compared them with

ledger balance; also, if the entries in the ledger accounts were checked with relevant invoices, it would have been discovered that these had not been posted on the true dates. On these facts, he concluded that if due care and skill had been exercised, the suppression of the invoices would have been discovered and held the auditor liable for the damages which the company had suffered due to understatement of liability in the Balance Sheet.

4. In Re : Republic of Bolivia Exploration Syndicate Ltd. (1913), held - That the auditors of a company in liquidation may be held liable for failure to detect ultra vires payments, but only in extreme cases will the liability be fully enforced.

In this case, a claim was brought against the auditor to make good certain payments which were held to be wrong and ultra vires, though the payments had not been made by the company in consequence of any report or audit by the auditors. It was contended that they had failed in their duty in passing the accounts without drawing attention to such payments and that in consequence the Balance Sheet did not show the true financial position, a fact which had put the company to loss.

5. In Re : City Equitable Fire Insurance Co. Ltd., held - That an auditor is not justified in omitting to make personal inspection of securities that are in the custody of a person or a company with whom it is not proper that they should be left.

In this case, an action had been brought by the Official Receiver as liquidator of the company against the directors and auditors for damages arising out of misfeasance. The chairman of the company was also the senior partner in the firm of Ellis & Co., the company's stock brokers who, at all material times, were heavily indebted to the company.

The principal charge against the auditors was that they had failed to detect and report to the shareholders that a number of company's securities, which were in the custody of Ellis & Co. were being pledged by the firm to its customers. The auditor had relied on the certificate of Ellis & Co. that these securities were held by them. The master of Rolls, on a consideration of the evidence led in this case, showed that it was customary for the auditor to obtain certificate from banks in respect of securities lodged with them and that the certificates were not accepted from brokers. He made the following obiter dicta which is of great significance to auditors.

"I think he (the auditor) must take a certificate from a person who is in the habit of dealing with, and holding securities, and who he, on reasonable grounds, rightly believes to the exercise of the best judgement a trustworthy person to give such a certificate."

6. In Re: Westminster Road Construction and Engineering Co. Ltd. (1932), held- That when there is time lag between the incurring of a liability and receipt of bills and at the time of audit, sufficient time had not elapsed for the invoices relating to such a liability to have been received it was the duty of auditor to make specific enquiries as to the existence of such liabilities. He also must check the valuation of the work in progress at which it is included in the Balance Sheet.

In this case, action had been brought against the auditor by the liquidator of the company in respect of payment of dividend when there were in fact no profits of which it could be paid. Negligence was alleged in respect of over valuation of work in progress, omission of liabilities,

7.18 Advanced Auditing and Professional Ethics

etc. The Court held that the auditor was liable to refund to the company the amount of dividend wrongly declared, with interest and costs.

7. In Re: S.P. Catterson and Sons Ltd. (1947), held - That the primary responsibility for the accountant of a company is of those who are in control of the company i.e. the directors.

In the case, an application had been made by the liquidator that the auditor of the company had been negligent in the performance of his duty and thus was liable to compensate the company in respect of amounts misappropriated by an employee of the company, which had become irrecoverable. Though the fact that the defalcation had occurred was accepted, the auditor contended that he had drawn the attention of the directors to the weakness of the system of recording cash and credit sales and had recommended its alteration; notwithstanding this, the system had been continued. Also, that the directors had failed to check adequately the cash records, at the time money was duly handed over, day to day, by the manager.

8. In Re: Continental Vending Machine Corporation (1970) An American Case - This is a significant case in as much as it seeks to provide guidelines for the exercise of auditor's judgement and discretion where conclusive accounting and auditing principles are not available to guide the auditor. In this case, the auditor was held guilty of not having reported a known fact. The President of the Continental Vending Machine Corporation caused the diversion of a substantial sum of money of the Corporation to his benefit by canalising it through an associated concern the audit of which was conducted by another. A substantial part of the security for this accommodation consisted of securities of the Continental Vending Co., itself. This was not reported and since the amount advanced by this company became irrecoverable, the auditors were held guilty of gross negligence.

The judgement is significant for what it says about the weight the law will attach to the standards of accounting profession and for what it says about obligations of an auditor over and above those imposed by the standards themselves. The test that the Court applied was not whether the balance sheet was in accordance with generally accepted accounting principles but whether the balance sheet fairly represented the financial position.

The Court held that though in ordinary case disposition of funds advanced by the client to its affiliates need not be disclosed by the auditor, such a disclosure becomes necessary in cases of: (i) looting; (ii) known dishonesty by a high official; (iii) corporation being operated to a material extent for the private benefit of its President; and (iv) dishonest diversion of funds. Thus the Court laid down a special rule for disclosure and emphasised that an auditor's approach should not necessarily be limited to the mere compliance with the accepted standards but should primarily be governed by the objective to establish an honest and fair representation of financial facts.

Damages must be suffered: In the various cases considered, it will be observed that when an auditor has been found guilty of professional negligence and a loss has been suffered, the Courts have held that the amount of loss should be made good by the auditor. For instance, in the case of Leeds Estate Building and Investment Co. Ltd. v. Shepherd, under a civil action by the liquidator, the auditor was held liable to make good, jointly with directors, the dividend paid out of capital.

Where, however, the loss has been occasioned through negligence of directors, the fault of the auditor in failing to verify the asset has been considered to be only technical and only nominal penalty has been imposed. For instance, in the case of *London Oil Storage Co. Ltd. v. Seear Husluck and Co.* £ 5. 5sh was awarded as damages against the auditor, although the loss was much more, on the ground that professional negligence had not occasioned the loss. In the case of *Armitage v. Brewer and Knot*, the auditors were held responsible even for the amount of defalcations which has taken place subsequent to their failure to detect fraud with regard to petty cash in an earlier period. It is the only case in which the principle of consequential damages has been applied to audit claims, i.e. if an auditor omits to detect a defalcation by an employee and, in the following year, before there is a chance of any further audit, the employee emboldened by the non-detection of the defalcation, embezzles a larger sum, the auditor would be liable both for the original loss which he had failed to detect and the subsequent loss suffered by the employer.

Apart from the liability for professional negligence, in the discharge of duties an auditor also may be penalised under section 147 of the Companies Act, 2013 for failure to comply with any of the provisions contained in sections 143 and 145. He incurs such a liability as auditor of the company.

[Note: Students may refer Chapter 6 for Punishment for Contravention as stated in Section 147]

7.5 Criminal Liability under the Companies Act

The circumstances in which an auditor can be prosecuted under the Companies Act, and the penalties to which he may be subjected are briefly stated below:

(i) **Criminal liability for Misstatement in Prospectus-** As per Section 34 of the Companies Act, 2013, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be liable under section 447.

This section shall not apply to a person if he-

proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

(ii) **Punishment for false statement** - According to Section 448 of the Companies Act, 2013 if in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement —

- (a) which is false in any material particulars, knowing it to be false; or
- (b) which omits any material fact, knowing it to be material,

he shall be liable under section 447.



Fig.: Criminal Liability*

Punishment for Fraud - As per Section 447 of the Companies Act, 2013, without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

It may be noted that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

Explanation — For the purposes of this section—

- (i) “fraud” in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;
- (ii) “wrongful gain” means the gain by unlawful means of property to which the person gaining is not legally entitled;
- (iii) “wrongful loss” means the loss by unlawful means of property to which the person losing is legally entitled.

Direction by Tribunal in case auditor acted in a fraudulent manner: As per sub-section (5) of the section 140, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

* Source: CA knowledge

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

7.5.1 Cases in which an auditor has been held to have incurred criminal liability:

1. Dambell Banking Co. Ltd. (1900) - The directors and auditors, in the case, were prosecuted under section 221 of the Criminal Code of 1872 which is similar to Section 143 of the Companies Act, 2013, for having joined in the issue of false balance sheets, knowing them to be false in material particulars, and with the intent to deceive and defraud shareholders of the company. From the facts provided, it was clear that the accounts were not only false but materially false; letters from the auditors to the managers showed that they (the auditors) thought that overdrafts were bad although taken in as good. They had told the managers that they held strong views about the overdraft, but did not state those views in their certificates to the shareholders. The jury found all the defendants (including the auditors) guilty, and they were sentenced to various terms of imprisonment.

2. Farrow's Bank Ltd. (1921) - In this case, there had been a considerable writing up of assets, obviously to show profits available for dividends. In one case a piece of property that cost £5,500 was written up to £7,80,000. The auditor was in the company's regular employment as its accountant and was convicted on various charges of conspiracy and fraud in connection with the published accounts of the bank, and sentenced to 12 months' imprisonment.

3. Rex v. Lord Kylsant and Another (1931) - (Known as the Royal Mail Steam Packet Company's Case) This was a criminal prosecution in which Lord Kylsant who was Chairman of the Board of Directors of Royal Mail Steam Packet Company was charged on two counts (a) of publishing an annual report for 1926, which he knew to be false in a material particulars and that the said report concealed from the shareholders the true position of the company, with intent to deceive the shareholders; and (b) of publishing an annual report for the year 1927, which he knew to be false in a material particular, with intent to deceive the shareholders. Mr. H.J. Morland the auditor, was charged with aiding and abetting Lord Kylsant to commit these offences. Both the accused were acquitted of respective charges, though Lord Kylsant was found guilty and convicted on a separate charge of publishing false prospectus for the issue of fresh debenture stock.

The facts of the case briefly were that the Profit and Loss Account for the year 1926 showed, 'Balance for the year, including dividends on shares in allied and other companies, adjustment of taxation reserves, less depreciation of fleet £4,30,212. Actually this apparent surplus had

7.22 Advanced Auditing and Professional Ethics

been arrived at on including undisclosed credits of £5,50,000 from excess Profit Duty, £2,75,000 from Income tax Reserve and £25,776 from investment Profit. If this was not done there would have been a considerable deficit. In 1927, with practically identical wording, a surplus of £2,24,907 was raised to £4,37,293 by similar credits totalling £2,12,386. It must be added that almost the entire amounts of these credits had no relation to the trading of the respective years 1926 and 1927. The contention of the crown was that such item, in the accounts conveyed "a deliberate false representation to the shareholders that the company was making a trading profit when, in fact, it was making a trading loss." The company, in fact, had been drawing upon its secret or hidden reserves from 1921 to 1927. The adjustment of these special credits enabled the company to pay its debenture interest, and dividends on both the preference and ordinary stocks.

N.B. The decision in the case has been principally responsible for the change in the phraseology of the auditor's report from 'true and correct' to 'true and fair' requiring a fuller disclosure of any non-trading income or that not belonging to the year, adjusted in the Profit and Loss Account.

4. Official Liquidator Karachi Bank v. The Directors, etc. of Karachi Bank Ltd. (1932) - The directors of the Bank made a statement in the balance sheet that the profit earned by the bank in 1927 amounted to ₹ 15,608. The amount of profit had been arrived at on taking credit for a sum of ₹ 45,214, an amount held in suspense for bad or doubtful items of interest. It was held that the official Liquidator should prosecute the managing directors, manager and the auditors for an offence under section 232 of the Indian Companies Act, 1913 (now section 448) of the Companies Act, 2013.

Wild J.C. said "What the Directors of the bank have done is to show a cash profit for the year by adding in a sum which is due, no doubt, but was never paid and was never likely to be paid. The balance sheet, therefore, contains a false statement and a very material one and I am unable to see how it can be argued that it was not intended to be misled."

7.6 Cases Concerning the Misconduct of Auditors under the Chartered Accountants Act

The code of conduct for an auditor should be taken into consideration and the different circumstances under which disciplinary action can be taken against a member; the decisions in a number of cases can be referred to. It being important, however for students to understand what constitutes 'gross negligence' in terms of Clauses 5 to 8 of Part I of the Second Schedule to the Chartered Accountants Act, two decisions by Indian Courts which have become legal classics, are considered below:

Deputy Secretary of the Government of India, Ministry of Finance v. S. N. Dass Gupta: In this case, action was brought against Shri S.N. Dass Gupta, a member of the Institute, in respect of alleged negligence in the audit of accounts of Aryan Bank Limited, for the years 1942 to 1944. It was alleged that the bank had resorted to manipulation of accounts on an extensive scale. One of the charges was that in 1944 the bank has shown in its Fixed Deposit Ledger certain large sums as having been received on fixed deposit from certain concerns in which the Managing Director was interested but the Cash Book of the bank did not show any corresponding entries on the relevant dates. Another charge was that though the auditor had

certain doubts as regard loans advanced against fixed deposits, he had not stated the position clearly. It was also alleged that on a certain date in 1944 the Cash Book showed a cash balance of ₹ 5,00,000 although the actual balance on the date was a little over ₹ 1,000. The auditor in defence submitted that he had not verified the cash balance in hand and had mentioned this fact in his Special Report. The learned judge in this regard observed:

“If an auditor does not do what it is his duty to do, it is no defence for him to say in disciplinary proceedings started under Chartered Accountants Act that he had told the shareholder that he had not done it. The lapse is constituted by his failure to verify a duty without which an audit is meaningless and it is not excused by giving information of the omission to the shareholders. Authorities both legal and professional are unanimous that in a bank audit the cash balance claimed by the management must be verified by the auditor because otherwise the management might remove the greater part of the funds and show them falsely as lying in hand in cash and thereby relieve themselves of the necessity of making up accounts showing the disposition of money. In the matter of cash the auditor is not entitled to rely on the certificate of the manager of accepted integrity, according to the principles laid down in the case Re: City Equitable Fire Insurance Co.”

In the matter of the second charge against the auditor that though he had some doubts and misgivings as regards certain losses which might be suffered by the bank due to certain overdrafts accounts proving to be irrecoverable, he had failed to qualify the report in certain terms indicating the true position of the debits and, instead, had made some cryptic remarks about them in his special report. The learned judge observed, “Either he knew that some of the debts were bad and some of the so called secured loans were not genuine, but he did not wish to inform the shareholders of that fact but wanted at the same time to provide for his own safety and, therefore, he inserted certain cryptic remarks in his Special Report; or he was careless and neglected to give the shareholders the information which it was his duty to give.”

It was held that the respondent has committed a grave wrong and in consequence he was suspended from the membership of the institute for two years.

The learned judge in his judgement also made the following observation as regards the duties of auditor and methods they should follow for discharging them satisfactorily:

(a) Ascertaining reporting, not only whether the balance sheet exhibits a true and fair state of affairs of the company, as shown by the books of the company, but also whether the books of the company themselves exhibit a true and fair state of the company's affairs.

If any matter has been kept out of the books, with the result that the auditor did not have access to it, he is not responsible for its non disclosure to the shareholders. In this regard the dictum, pronounced by Rigby L.J. in the case Re : London & General Bank, that the words as shown by the books of the company, contained, in the report which the auditors make on the statements of account relieve them the responsibility as regards disclosure of the affairs of the company kept out of the books can be followed.

(b) Verifying not merely the arithmetical accuracy of the statements of account but also their substantial accuracy by confirming that they include all the particulars requiring disclosure by

7.24 Advanced Auditing and Professional Ethics

the Articles or the Companies Act and otherwise represents true and fair state of affairs of the company.

(c) Checking the accounts and verifying the financial statements with reasonable care and skill. For the purpose, the auditor may properly rely on the statements of the director-in-charge or the Mg. Director but only if he is satisfied that the representations made by him appear to be an honest and truthful. All matters which are capable of direct verification should generally be verified directly. But matters which require investigation rather than checking may be verified on the basis of representation of officers of accepted competence and integrity provided there is nothing unusual in the accounts.

(d) Examining the books of the company and obtaining such information or explanation which he considers necessary but not with suspicious mind or by proceeding in a manner he would adopt for detecting a fraud or a lie subject, however, to the fact that he is not in possession of any information which excites suspicion or ought to excite suspicion of a professional man of reasonable competence.

(e) Verifying the existence of assets and liabilities.

(f) Making a report to the shareholders as would give them information and not merely means of information, in order that the shareholders may judge the position of the company for themselves. If the auditor is not satisfied as to the accuracy of entries in the balance sheet or they are such that, if disclosed, they would show the balance sheet in a different way, these facts must be conveyed to the shareholders.

Controller of Insurance vs H. C. Das: In this case, action was brought against Messers H.C. Dass & Co. by the Central Government in the matter of audit of accounts of Bhagya Laxmi Insurance Limited. The auditors had audited the accounts of the company from 1936 until 1951 and had issued the certificate required under Regulations 7(c) and 7(d) of Part I of the First Schedule to the Insurance Act, 1938. On the appointment of the administrator subsequently under Section 52A of the Insurance Act, a number of irregularities were discovered. The principal defence of the auditor in respect of the charges was that he had relied on statements of the management in regard to matters included in the statements certified by him. During the course of the judgement, the learned judge made the following observation:

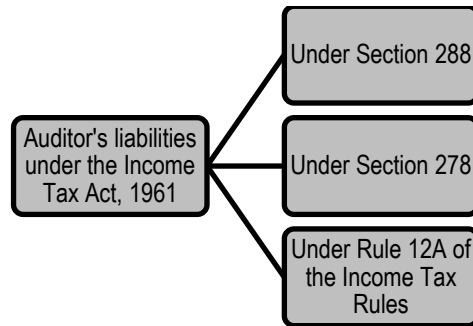
“As has been said, an auditor is not only blood hound, but he is not also an insurer. He does not certify the absolute accuracy of the accounts which he audits and approves of, but only says that he has taken all possible care and exercised reasonable skill and having done so has arrived at the conclusions which are recorded in his certificate. But if, as we find to our regret to have been the position here, an auditor does nothing at all in the way of scrutinising the books of the company, but only relies upon statements made to him by the management, as his own case find it impossible to hold that he exercised any skill or care of any kind.

“An auditor who construes his duty to shareholders or policy holders too narrowly and who passes and approves of whatever is stated to him by the management of the company whose accounts he audits does not serve the shareholders with the loyalty or efficiency expected of him and constitutes, instead of a source of security to the shareholders, a positive danger to them.”

The auditor was held guilty of gross negligence.

7.7 Liabilities under Income Tax Act 1961

In connection with proceedings under the Income Tax Act 1961, a Chartered Accountant often acts as the authorised representative of his clients and attends before an Income Tax Authority or the appellate tribunal. His liabilities under the Income Tax Act of 1961 are as below:



(i) Under Section 288: A person who has been convicted of any offence connected with any Income Tax proceeding or on whom a penalty has been imposed under the said Act (except under clause (ii) of sub section (1) of Section 271) is disqualified from representing an assessee. The Chief Commissioner/Commissioner of Income Tax has been given powers to determine the period of such disqualification of a person.

A Chartered Accountant found guilty of professional misconduct in his professional capacity by the Council of the Institute of Chartered Accountants of India, can not act as an authorised representative (for any matter within the definition of a member in practice) for such time that the order of the Council disqualifies him from practising.

(ii) Under Section 278: Any person who acts or induces, in any manner another person to make and deliver to the Income Tax Authorities a false account, statement, or declaration, relating to any income chargeable to tax which he knows to be false or does not believe to be true.

(iii) Under Rule 12A of the Income Tax Rules: Under this rule a Chartered Accountant who as an authorised representative has prepared the return filed by the assessee, has to furnish to the Assessing Officer, the particulars of accounts, statements and other documents supplied to him by the assessee for the preparation of the return.

Where the Chartered Accountant has conducted an examination of such records, he has also to submit a report on the scope and results of such examination. The report to be submitted will be a statement within the meaning of Section 277 of the Income Tax Act. Thus if this report contains any information which is false and which the Chartered Accountant either knows or believes to be false or untrue, he would be liable to rigorous imprisonment which may extend to seven years and to a fine.

8.1 Auditor's Opinion



Assuming you are an auditor and concluded the audit work, your next step will be issuance of the audit report. An audit report is very important medium of communication i.e. auditor's expert views on the financial statements and it has a significant bearing on the credibility of such statements. By expressing views in the report, the auditor takes upon himself a great responsibility because a large number of people are likely to put reliance on the financial statements. Therefore, the auditor is necessarily to be careful, clear and objective in the matter of preparation of the report. The report should also be as simple as the circumstances permit.

Fig. : Audit Opinion*

8.2 The Auditor's Report on Financial Statements:

The SA 700 series is purely dedicated to the auditor report to be issued by the auditor. There are following SAs which you need be aware of:

Particulars	Head	Purpose	Effective Date
SA-700 (Revised)	Forming an Opinion and Reporting on Financial Statements	<ul style="list-style-type: none"> Forming opinion on the financial statements. Form and content of the audit report. 	1 st April 2017
SA-701 (newly introduced)	Communicating Key Audit Matters in the Independent Auditor's Report	<ul style="list-style-type: none"> To enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. To assist the user in 	1 st April 2017

* Source: www.simplilearn.com

		<i>understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.</i>	
SA-705 (Revised)	Modifications to the Opinion in the Independent Auditor's Report	<ul style="list-style-type: none"> • <i>To issue an appropriate audit report when the auditor considers the modification in an audit report is necessary.</i> • <i>To deal with the revised form and content when the modification of the opinion take place.</i> 	1st April 2017
SA-706 (Revised)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	<p><i>To draw user's attention Draw users' attention to a matter or matters:-</i></p> <ul style="list-style-type: none"> • <i>Presented or disclosed in the financial statements and which is fundamental for the understanding of the user, or</i> • <i>Not presented or disclosed in the financial statement and which is relevant for the understanding of the user.</i> 	1st April 2017

8.2.1 SA-700, "Forming an Opinion and Reporting on the Financial Statements":

It deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

Objective: *As per SA 700 the objectives of the auditor are:*



Fig.: Audit Report*

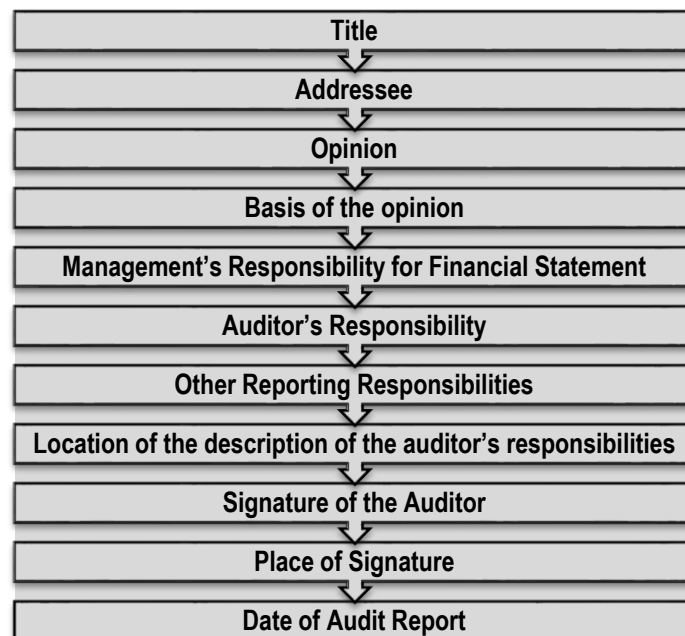
** Source: hubpages.com*

(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) To express clearly that opinion through a written report.

Purpose: The requirements of this SA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Basic Elements of the Auditor's Report: As per SA 700 "Forming an opinion and reporting on financial statements", the auditor's report includes the following basic elements, which ordinarily includes in case of Auditors's Report for Audits Conducted in Accordance with Standards on Auditing:



1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

Example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

2. **Addressee:** *The auditor's report shall be addressed as required by the circumstances of the engagement.*
3. **Auditor's Opinion :** *The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."*

The Opinion section of the auditor's report shall also:

- (a) *Identify the entity whose financial statements have been audited;*
- (b) *State that the financial statements have been audited;*
- (c) *Identify the title of each statement comprising the financial statements;*
- (d) *Refer to the notes, including the summary of significant accounting policies; and*
- (e) *Specify the date of, or period covered by, each financial statement comprising the financial statements.*

When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (i) *In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or*
- (ii) *In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework].*

When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

If the reference to the applicable financial reporting framework in the auditor's opinion is not to Accounting Standards, the auditor's opinion shall identify the origin of such other framework.

4. **Basis for Opinion :** *The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:*
 - (a) *States that the audit was conducted in accordance with Standards on Auditing;*
 - (b) *Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;*
 - (c) *Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI*
 - (d) *States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.*

5. Going Concern: Where applicable, the auditor shall report in accordance with SA 570 (Revised).¹

6. Key Audit Matters: For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

7. Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance.

This section of the auditor's report shall describe management's responsibility for:

- (a) *Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and*
- (b) *Assessing the entity's ability to continue as a going concern² and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.*

This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in next paragraph. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to entity.

When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

8. Auditor's Responsibilities for the Audit of the Financial Statements : The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

This section of the auditor's report shall:

¹ SA 570 (Revised), *Going Concern*, paragraphs 21–23

¹⁴ SA 570 (Revised), paragraph 2

- (a) **State that the objectives of the auditor are to:**
- (i) **Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and**
 - (ii) **Issue an auditor's report that includes the auditor's opinion.**
- (b) **State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and**
- (c) **State that misstatements can arise from fraud or error, and either:**
- (i) **Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or³**
 - (ii) **Provide a definition or description of materiality in accordance with the applicable financial reporting framework.**

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

- (a) **State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and**
- (b) **Describe an audit by stating that the auditor's responsibilities are:**
- (i) **To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.**
 - (ii) **To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.**

¹⁵ SA 320, Materiality in Planning and Performing an Audit, paragraph 2

- (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.*
 - (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.*
 - (v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.*
- (c) When SA 600, "Using the Work of Another Auditor", applies, further describe the auditor's responsibilities in a group audit engagement by stating:*

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

- (a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;*
- (b) State that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and*
- (c) For audits of financial statements of all such entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are*

therefore the key audit matters. In accordance with the requirements of SA 701, the auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

9. Location of the description of the auditor's responsibilities for the audit of the financial statements: The description of the auditor's responsibilities for the audit of the financial statements required by this SA shall be included:

- (a) Within the body of the auditor's report;**
- (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or**
- (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or the auditing standards expressly permit the auditor to do so.**

When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements of this SA.

10. Other Reporting Responsibilities:

- (a) If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.**
- (b) If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.**
- (c) If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of this SA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."**

11. Signature of the Auditor: The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the

8.9 Advanced Auditing and Professional Ethics

membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

The report is to be signed by the maker of the report. Normally, a chartered accountant in practice signs the report in the name he is registered as a practitioner. If he is an individual, it may be his individual name or the firm name of which he is the sole proprietor. For those who practise as a partnership, it is usual for them to sign in the firm name. Under Section 145 read with Section 141(2) of the Companies Act, 2013, only the person appointed as an auditor of the company or, where a firm is so appointed, only the partner in the firm who is a chartered accountant, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

It is obvious that the person appointed makes the report; otherwise the very essence of the appointment of a particular man or firm will be lost. In a profession, the particular skill and reputation of the practitioner counts considerably and if anybody else is allowed to make the report on behalf of the person appointed, then this confidence in the person will cease to be a factor. This has other implications also from the point of view of professional responsibility; it will create an unusual legal situation. It has also implications from the standpoint of the practitioner. If in respect of appointments held by him, the reports are made by others, gradually the goodwill of the practitioner will end and the clients may shift to the person actually making the report.

Example:

If A, B and C were in practice as ABC & Co. Chartered Accountants, any of A or B or C could sign as "ABC & Co." in his own hand. But now in view of the objection raised by the Department of Company Affairs to this practice, the Council of the Institute in the SA 700 "The Auditor's Report on Financial Statements" has recommended to the members who are in practice in partnership that signature on or authentication of the auditor's report or any other document required to be signed or authenticated by the auditor should be made in the following manner.

For ABC and Co.
Chartered Accountants
Firm Registration Number
Signature
(Name of the Member Signing the Audit Report)
(Designation)⁴

In addition to the provisions of the Companies Act, 2013 referred to above, Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949 provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he allows a person, not being a member of the Institute or a member not being his partner, to sign on his

⁴ Partner or Proprietor, as the case may be.

behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements. The provision is intended to safeguard the professional purity by excluding non-chartered accountants from signing the aforesaid documents. By excluding chartered accountants who are not partners, it seeks to keep the line of professional responsibility clear. Partners are mutual agents and therefore, allowing a partner to sign does not interfere with the clarity of responsibility.

12. Place of Signature : *The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.*

13. Date of the Auditor's Report: *The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:*

- (a) *All the statements that comprise the financial statements, including the related notes, have been prepared; and*
- (b) *Those with the recognized authority have asserted that they have taken responsibility for those financial statements.*

Auditor's Report Prescribed by Law or Regulation: *If the auditor is required by law or regulation applicable to the entity to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:*

- (1) *A title.*
- (2) *An addressee, as required by the circumstances of the engagement.*
- (3) *An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.*
- (4) *An identification of the entity's financial statements that have been audited.*
- (5) *A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.*
- (6) *Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements of SA 570 (Revised).*
- (7) *Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements of SA 570 (Revised).*
- (8) *Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and*

that addresses, and is not inconsistent with, the reporting requirements in that SA.⁵

- (9) A description of management’s responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements.*
- (10) A reference to Standards on Auditing and the law or regulation, and a description of the auditor’s responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements.*
- (11) The auditor’s signature.*
- (12) The Place of signature*
- (13) The date of the auditor’s report.*

Auditor’s Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction:

An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor’s report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

- (a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:***
 - (i) to form a different opinion, or***
 - (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and***
- (b) The auditor’s report includes, at a minimum, each of the elements set out in Auditor’s Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to “law or regulation” in above paragraph shall be read as reference to the Standards on Auditing. The auditor’s report shall thereby identify such Standards on Auditing.***

When the auditor’s report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor’s report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

Supplementary Information Presented with the Financial Statements: If supplementary information that is not required by the applicable financial reporting framework is presented

⁵ SA 701, paragraphs 11–16

with the audited financial statements, the auditor shall evaluate:

- *whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.*
- *whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.*

8.2.2 SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report":

This SA 701 provide guidance regarding communication of Key Audit Matters. Key Audit matter are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

Purpose: The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

Scope: Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- (a) *A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;*
- (b) *A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);*
- (c) *A substitute for reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or*
- (d) *A separate opinion on individual matters.*

This SA applies to audits of complete sets of general purpose financial statements of listed entities and circumstances when the auditor otherwise decides to communicate

key audit matters in the auditor's report. This SA also applies when the auditor is required by law or regulation to communicate key audit matters in the auditor's report. However, SA 705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation.

Determining Key Audit Matters: The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315*
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.*
- (c) The effect on the audit of significant events or transactions that occurred during the period.*

Communicating Key Audit Matters: The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and.*
- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.*

Illustration

The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

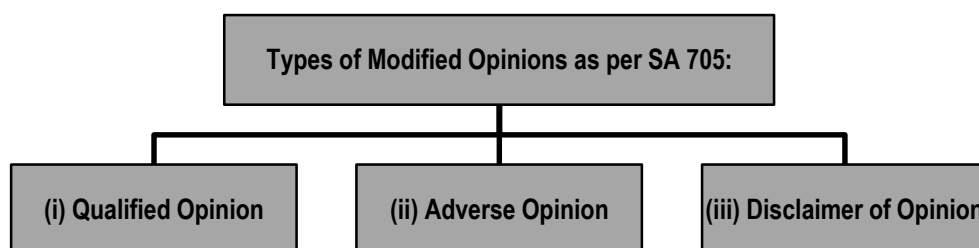
[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.]

8.2.3 SA 705, "Modifications to the Opinion in the Independent Auditor's Report":

Modified Opinions: SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The succinct requirements of this SA 705 are given below -

Types of Modified Opinions:



The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Objective: The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Circumstances When a Modification to the Auditor's Opinion is Required:

The auditor shall modify the opinion in the auditor's report when:

- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Determining the Type of Modification to the Auditor's Opinion:

Qualified Opinion: The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

CASE STUDY

“The Company’s financing arrangements expire and amounts outstanding are payable on May 19, 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company’s ability to continue as a going concern and therefore the Company may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.” You are required to identify the type of opinion and draft the same.

In view of circumstances mentioned in SA 705, the auditor should give **Qualified Opinion** in above case. Draft qualified opinion is given as under;

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Companies Act, 2013, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X1;
- (b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and
- (c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

CASE STUDY

“The Company’s financing arrangements expired and the amount outstanding was payable on March 31, 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company’s ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.” You are required to identify the type of opinion and draft the same.

In view of circumstances mentioned in SA 705, the auditor should give **Adverse Opinion** in above case. Draft qualified opinion is given as under;

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013, in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X0; and
- (b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date; and
- (c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- (b) **If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:**
 - (i) **Withdraw from the audit, where practicable and possible under applicable law or regulation; or**
 - (ii) **If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.**

If the auditor withdraws, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

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

Form and Content of the Auditor's Report When the Opinion is Modified

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section.

What special consideration needed for expressing Qualified Opinion?

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or***
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].***

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

What special consideration needed for expressing Adverse Opinion?

When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or***
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].***

What special consideration needed for expressing Disclaimer of Opinion?

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- (a) State that the auditor does not express an opinion on the accompanying financial statements;***
- (b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and***
- (c) Amend the statement required in SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.***

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

What is the Basis for Modification of Opinion (Qualified/Disclaimer /Adverse)?

When the auditor modifies (Qualification/Disclaimer/Adverse) the opinion as above on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- (a)** Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- (b)** Within this section, include a description of the matter giving rise to the modification.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- (a)** Discuss the non-disclosure with those charged with governance;
- (b)** Describe in the Basis for Opinion section the nature of the omitted information; and
- (c)** Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

8.19 Advanced Auditing and Professional Ethics

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion to include the word "qualified" or "adverse", as appropriate.

When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include following elements required under SA 700

- (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
- (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

How Auditor will give description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements?

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
- (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) The statement about auditor independence and other ethical responsibilities required in SA 700 (Revised).

Communication with Those Charged with Governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

8.2.4 SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report":

Objective: The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- (a) *A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or*
- (b) *As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.*

Emphasis of Matter paragraph – *A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.*

Other Matter paragraph – *A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.*

When to give emphasis of Matter Paragraphs in the Auditor's Report?

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- (a) *The auditor would not be required to modify the opinion in accordance with SA 705 (Revised)³ as a result of the matter; and*
- (b) *When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.*

These circumstances may include:

- *When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.*
- *To alert users that the financial statements are prepared in accordance with a special purpose framework.*
- *When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).*

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) *Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";*
- (b) *Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and*

- (c) *Indicate that the auditor's opinion is not modified in respect of the matter emphasized.*

When to issue other Matter Paragraphs in the Auditor's Report?

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

- (a) *This is not prohibited by law or regulation; and*
(b) *When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.*

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.*
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.*
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.*
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.*

Is there any duty communication with Those Charged with Governance?

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

Illustration of Emphasis of Matter Para

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of ABC Company Limited (“the Company”), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company’s branches located at (*location of branches*))¹³.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view*, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI’s Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company’s production facilities. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

Other Matter

The financial statements of ABC Company for the year ended March 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised) given in Auditing Pronouncement.]

- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
- (j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-
 - (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
 - (iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

The opinions which the auditor is required to express are:

- (i) Whether proper books of account as required by law have been kept by the company so far as it appears from the examination of the books and proper returns adequate for the purposes of the audit have been received from branches not visited by him;
- (ii) Whether the accounts give the information required by the Act in the manner so required;
- (iii) Whether in his opinion, the statement of profit and loss and balance sheet complied with the accounting standards referred to in Section 133;
- (iv) Whether the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year.

However, it should not be understood that a distinct statement of a fact makes it unnecessary to consider the same for the purpose of opinion formation. In effect, the facts, apart from their own significance which probably account for their, distinct disclosure, are complementary to the opinion. On the face of adverse facts, no favourable opinion can be given. It should be appreciated that only certain very important and basic facts about the accounts are required to be stated under the provisions of sub-sections (3). The statement of facts by the auditor is a very significant pointer to the credibility of the accounts. If the auditor states that he has not been able to obtain all the information and explanations considered necessary by him, the reliability of the accounting information under the report would be seriously impaired. Sub-section (4) provides for reasons to be given in the auditor's report, if any of the matters required to be included in the audit report under this section are subject to qualification or negative statement.

Note: Students are also required to refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013 given in Appendix at the end of this Chapter.

Report under Section 143(1) of the Companies Act, 2013: Section 143(1) requires the auditor to make certain specific enquiries during the course of his audit. This requirement is without prejudice to his general rights, powers and duties regarding access to books etc. and obtaining

8.25 Advanced Auditing and Professional Ethics

information and explanations. He is however not required to report on the matters specified in this sub-section, unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It should however be noted that the auditor is required to make only enquiries on the matters specified in the sub-section and is not to investigate into the matters referred to therein.

Clause (a) requires the auditor to inquire:

“Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members.”

This clause applies to loans and advances made by the company during the financial year under audit, whether they are outstanding on the date of the Balance Sheet or not. The inquiry should be made in the light of conditions prevailing when the loan or advance was made. Loans and advances have not been defined anywhere in the Act. However, having regard to the requirement of clause (d) of this sub-section, a distinction is obviously intended to be made between “loans and advances” and “deposits”. A “deposit” may be defined as the placing of money or money’s worth with a third party, either for safe keeping, or by way of security for the performance of the depositor’s obligations, or for the purpose of earning interest; in the last case deposit being with a party who customarily accepts deposits. Any item required to be disclosed under the head “Loans and Advances” in Part I of the Schedule III to the Act which do not fall within the above definition of a “deposit” should be construed for the purpose of this clause as “loans and advances”.

The clause applies to all loans and advances made “on the basis of the security”. “Security” for this purpose would include any movable or immovable property, whether belonging to the borrower or not, of which either physical possession or over which a legally effective charge is given to lender.

The loan agreement or correspondence in regard to the terms of the loan or advance should be seen. Where the loan or advance is made to a company, any charge on the assets of such a company should have been registered under Section 77 of the Act in order to constitute an effective security. The “terms” on which the loan or advance is made would primarily include the security, the interest charged and the terms of repayment. It would be difficult to lay down any general principles regarding the rate of interest which may be charged on loans and advances. Various considerations, such as the position and standing of the borrower, type of security, purpose of the loan, prevailing market rate of interest, etc., would have to be taken into account. If the loan has been given for business considerations, e.g., loans to staff for purchase of cars, houses, etc., loans to suppliers of raw materials or other goods, there may be justification for interest being charged at a rate lower than the market rate, or even, in appropriate circumstances, no interest being charged at all. However, when a loan is given only with a view to earning interest, the interest charged would be at the commercial rate.

Particular attention should be paid to loans or advances to concerns in which the directors of the company or their associates are interested. The question whether the terms on which a loan or advance has been made are “prejudicial to the interests of the company or its members” is a

difficult one. Obviously, the auditor is not to inquire as to how such transactions of the company affect the interests of individual members in their personal capacities. The reference to "members" should therefore be construed as a reference to the members of a company as a class, in their capacity as members. The members of the company would be primarily interested in a reasonable return on their investment and in the safety of their capital. The question whether a loan is prejudicial to the interests of the members should therefore be considered from this angle.

If loan or advance has been approved by the members of the company and/or the Government as required by Section 186, this would be a *prima facie* evidence to show that it is not prejudicial to the interests of the company or its members.

Under Clause (b) the auditor has to inquire:

"Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company."

The transactions of a company are ordinarily matters of fact. The purpose of book entries is to correctly record transactions which have, in fact, taken place. If a book entry is passed which is not in accordance with the facts of the transaction, or is contrary thereto, this should be set right or reported upon by the auditor. Again, if book entries are passed purporting to record "transactions" which have, in fact, not taken place, similar considerations would apply. The clause is therefore intended to cover transactions of the company for which the only evidence, or the principal evidence, is the entry regarding the transactions in the books of account. In such cases, the auditor should inquire whether such transactions have in fact taken place and, if so, whether they are prejudicial to the interests of the company.

Under Clause (c) the auditor has to inquire:

"Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company".

This clause requires the auditor to inquire in all cases where shares, debentures or other securities have been sold at a price less than their cost. If, as a result of his inquiries, the auditor is satisfied that the sale is *bonafide* and the price realised is reasonable, having regard to the circumstances of the case, he has no further duty to report on the matter.

Under Clause (d) the auditor has to inquire:

"Whether loans and advances made by the company have been shown as deposits".

A reference is invited to the definition of a "deposit" in contradistinction to that of a loan or advance given in the comments on clause (a) above. It should be noted that the inquiry to be made is whether loans and advances have been shown as deposits, and not vice versa.

Clause (e) requires the auditor to inquire:

"Whether personal expenses have been charged to revenue account."

The practice of meeting certain types of personal expenses of employees is normal and is recognized both by the Income tax Authorities and the Company Law Board. Illustration of such

8.27 Advanced Auditing and Professional Ethics

expenses are the provision of rent-free quarters, conveyance for personal use, medical expenses, expenses on leave travel, maternity benefits, canteen facilities, etc. The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate and does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon.

Clause (f) requires the auditor to inquire:

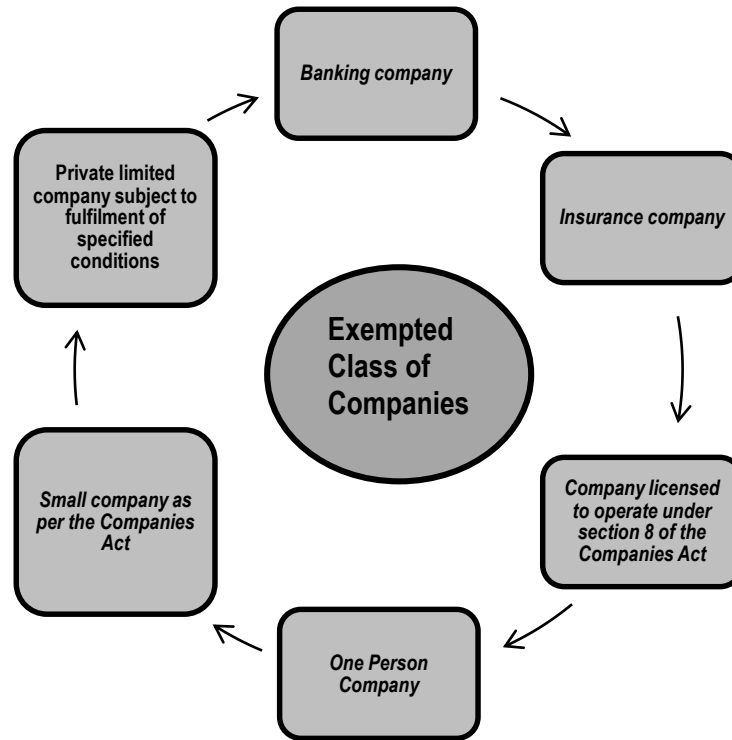
"Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading."

8.3 Reporting Under CARO, 2016

In exercise of the powers conferred by section 143(11) of the Companies Act, 2013, the Central Government, after consultation with the Institute of Chartered Accountants of India, has issued the Companies (Auditor's Report) Order, 2016, (CARO, 2016) dated 29th March, 2016.

8.3.1 Applicability of the Order: The CARO, 2016 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013. However, the Order specifically exempts the following class of companies

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);***
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);***
- (iii) a company licensed to operate under section 8 of the Companies Act;***
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and***
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.***



8.3.2 Auditor's report to contain matters specified in paragraphs 3 and 4. - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable: It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements.

8.3.3 Matters to be included in the auditor's report. - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;

- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,**

 - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;**
 - (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;**
 - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;**
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.**
- (v) in case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?**
- (vi) whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.**
- (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;**

 - (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).**
- (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).**

- (ix) *whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;*
- (x) *whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;*
- (xi) *whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;*
- (xii) *whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;*
- (xiii) *whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;*
- (xiv) *whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;*
- (xv) *whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;*
- (xvi) *whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.*

Examples

1. **ABC Pvt. Ltd. is a holding company of XYZ Ltd. Whether CARO is applicable to ABC Pvt. Ltd.?**
- CARO 2016 will be applicable to a private limited company which is holding company of a public company, which was not there in previous CARO. Therefore, CARO is applicable on ABC Pvt. Ltd.**

2. *Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.*

Reporting for Physical Verification of Inventory: clause (ii) of Para 3 of CARO, 2016 requires the auditor to state in his report whether physical verification of inventory has been conducted at reasonable interval by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification.

In the given case, the above requirement of CARO, 2016 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

3. *K Ltd. has taken a term loan from a nationalized bank in 2010 for ₹ 200 lakhs repayable in five equal instalments of ₹ 40 lakhs from 31st March, 2011 onwards. It had repaid the loans due in 2011 & 2012, but defaulted in 2013, 2014 & 2015. As the auditor of K Ltd. what is your responsibility assuming that company has sought reschedulement of loan?*

Reporting for Default in Repayment of Dues: As per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to report whether the Company has defaulted in repayment of its dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

In this case, K Ltd. has defaulted in repayment of dues for three years. Application for rescheduling will not change the default position. Hence the auditor has to report in his audit report that the Company has defaulted in its repayment of dues to the bank to the extent of ₹ 120 lakhs.

4. *LM Ltd. had obtained a Term Loan of ₹ 300 lakhs from a bank for the construction of a factory. Since there was a delay in the construction activities, the said funds were temporarily invested in short term deposits.*

Term Loan Invested in Short Term Deposits: As per clause (ix) of Para 3 of CARO, 2016, an auditor need to state in his report that whether the term loans were applied for the purpose for which the loans were obtained.

In the present case, the term loan obtained by LM Ltd. have not been put to use for construction activities and temporarily invested the same in short term deposit. Here, the auditor should report the fact in his report that pending utilization of the term loan for construction of a factory, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned as per clause (ix) of Para 3 of CARO, 2016.

5. **For the purpose of availing exemption from CARO what kind of loan to be considered?**
All sorts of loan whether term loan, demand loan, export credit, working credit limits, cash credits. Overdrafts, bill purchased or discounted, but does not include non-fund based facilities like LC BG.
6. **Whether CARO is Applicable to the auditor of consolidated financial statement? Order shall not apply to the auditor's report on consolidated financial statements. In previous order it was not expressly provided hence CFS auditors used to include CARO in their report.**
7. **What documents Constitute Title Deed?**
Following constitute title deeds of the immovable property:-
- (i) *Registered sale deed / transfer deed / conveyance deed, etc. of land, land & building together, etc. purchased, allotted, transferred by any person including any government, government authority / body / agency/ corporation, etc. to the company.*
- (ii) *In case of leasehold land and land & buildings together, covered under the head fixed assets, the lease agreement duly registered with the appropriate authority.*
8. **Should the auditor examine the cost record in detail while reporting under CARO?**
CARO does not require a detailed examination of Cost Records. The Auditor should, therefore, conduct a general review of Cost Records to ensure that the records as prescribed are made and maintained. The word "made" applies in respect of Cost Accounts, and the word "maintained" applies in respect of Cost Records relating to Materials, Labour, Overheads, etc.

8.3.4 Reasons to be stated for unfavourable or qualified answers-

- (1) *Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.*
- (2) *Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.*

(Note : Refer Appendix for Illustrative report)

8.4 Distinction between Audit Report and Certificate

The term 'report' is used where an expression of opinion is involved. The term 'certificate' is preferable where the auditor comments on or verifies facts such as a verification of investment by inspection or the checking of ballot papers on a poll in a company meeting. Under the Companies Act, 2013, a number of situations are there where an auditor is required to issue a certificate rather than a report like as per Section 66 of the Companies Act, 2013, an auditor is

8.33 Advanced Auditing and Professional Ethics

required to file a certificate in the tribunal where company proposing for the reduction of capital. However, the report under Section 143 of the Companies Act, 2013, is an opinion based report and is not a certificate.

Some situations where Audit Reports and Certificates are required is given below -

(1) *Under the Payment of Bonus Act, 1965, a chartered accountant may be required to issue a 'report' on the computation of bonus payable. The report may be as under:*

"We have reviewed the figures in the above computation in comparison with the books and records produced to us, the audit of which has already been completed by us and report that subject to the notes given on face of the computation in our opinion, and to the best of our knowledge and belief and according to the information and explanation given to us, the above computation is in due accordance therewith and has been made on a basis reasonably consistent with the provisions of the Payment of Bonus Act, 1965."

Place:

For X & Co.

Date:

Chartered Accountants

(2) *Auditor's Report in accordance with Regulation 54 of the SEBI (Mutual Fund) Regulations, 1993.*

- (i) All Mutual funds shall be required to get their accounts audited in terms of a provision to that effect in their trust deeds. The Auditor's Report shall form a part of the Annual Report. It should accompany the Abridged Balance Sheet and Revenue Account. The auditor shall report to the Board of Trustees and not to the unit holders.
- (ii) The auditor shall state whether:
 1. He has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit.
 2. The Balance Sheet and the Revenue Account are in agreement with the books of account of the fund.
- (iii) The auditor shall give his opinion as to whether:
 1. The Balance Sheet gives a true and fair view of the scheme wise state of affairs' of the fund as at the balance sheet date, and
 2. The Revenue Account gives a true and fair view of the scheme wise surplus/deficit of the fund for the year/period ended at the balance sheet date.

MANNER OF SIGNING OF CERTIFICATES BY CHARTERED ACCOUNTANTS:

The Council of the Institute of Chartered Accountants of India (ICAI), at its 349th meeting held on 17th and 18th January, 2016 considered an issue relating to manner of signing of certificates by Chartered Accountants. The Council noted that presently different practices were in vogue in respect of the manner of signing of various certificates issued by the members of the ICAI. On a consideration of the matter, the Council, with a view to

bring uniformity in the manner of signing of certificates, has decided to require the members of the ICAI to include (in addition to any other requirements in this regard prescribed by the relevant law or regulation under which the certificate is being issued) the following details in their "Signatures" on the certificates issued by them:

- *Name of the CA firm**
- *Firm Registration Number (FRN)**
- *Name of the member*
- *Designation (Partner/Proprietor)*
- *Membership Number*

8.5 Audit Reports and Certificates for Special Purposes

In this first part, the relevant extracts from the Guidance Note on Audit Reports and Certificates for Special Purposes are given below (Also refer SA 800, SA 805 and SA 810):

Government authorities may, under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates to specific requirements of the individual users is unlike a 'general purposes report' e.g. an auditor's report on financial statements which is intended for general use. An audit report or certificate for special purposes is one to which the format of general purpose audit report is not applicable.

8.5.1 Scope of Special Purpose Audit Reports and Certificates: Audit reports or certificates for special purposes may be issued in connection with:

- (a) financial statements which are prepared in addition to general purpose financial statements;
- (b) specified elements, accounts or items of financial statements;
- (c) compliance with requirements of any agreement or statute or regulation;
- (d) financial information given in special purpose formats or schedules; or
- (e) compilation of statistics or ascertainment of basic figures e.g., for the purposes of fixed quotas or levies.

8.5.2 Responsibility for Preparation of Special Purpose Statements: The primary responsibility for the contents of special purpose statement rests with the enterprise and this would be evidenced by a suitable declaration or authentication by the management on the face of the statement.

8.5.3 Scope of Reporting Auditor's Function: A reporting auditor should have a clear understanding of the scope and nature of the terms of his assignment. It is desirable for him to obtain the terms in writing to avoid any misunderstanding. A reporting auditor is not an expert on purely technical matters and as such, when he is required to report on or certify such matters (e.g., composition or quality of a product) which are of paramount importance and constitute the

very basis of the figures contained in the statement, he should state his limitations clearly in the report or certificate. At the same time he should indicate the extent to which he has been able to exercise his own professional skill and judgement with regard to the matters being reported upon. For instance, he may state that, for the purposes of forming his opinion he has relied upon a certificate from technical experts. He should, of course, satisfy himself about the technical qualifications of the expert, and subject the expert's certificate to a reasonable review.

8.5.4 Contents of Reports and Certificates for Special Purposes: In many cases, a reporting auditor can choose the form and contents of his report or certificate. In other cases the form and contents of the report or certificate are specified by statute or notification and hence cannot be changed. Where a reporting auditor is free to draft his report or certificate, he should consider the following:

- (a) Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
- (b) The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
- (c) If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
- (d) Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.
- (e) Reference to the information and explanations obtained should be included in the report or certificate. In certain cases, apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.
- (f) The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
- (g) If the special purposes statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached herewith. It should be clearly indicated whether or not the statutory audit of the general purposes financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purposes financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his co-operation and in appropriate circumstances, discuss relevant matters with him, if possible.
- (h) Where a report requires the interpretation of statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient

care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.

(i) An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.

(j) The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the suggestion made in above para to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

8.5.5 Extent of Reliance on General Purpose Audit Report: Where a special purpose engagement is undertaken after the statutory audit has been completed, a reporting auditor should invariably review the statutory audit report to ascertain whether there are any matters which have a bearing on his report or certificate. In cases, where a reporting auditor is required to report or certify certain specific matter arising from the financial statements taken as a whole, he should not normally issue his report or certificate until the statutory audit has been completed. For instance, a reporting auditor may be required to state whether, in the case of an Indian branch of a foreign company, the profit shown in the accounts represents the remittable surplus of the branch, or he may be asked to report on the computation of 'gross profit' for the purpose of bonus under the Payment of Bonus Act, 1965. In such cases, it would normally not be proper for him to give his report or certificate until the statutory audit has been completed, since he would not really be in a position to state whether the profit shown in the accounts itself has been properly computed.

Where an audit report or certificate is required before the statutory audit is completed, a reporting auditor should state clearly in his audit report or certificate that he is reporting on or certifying specific matters arising out of the financial statements of the enterprise, the statutory audit of which has not been completed. Where the reporting auditor prepares his report or certificate on the basis of duly audited general purpose financial statements he may take the following precautions:

- (i) He may clearly state in his report or certificate that the figures from the audited general purpose financial statements have been used and relied upon.
- (ii) He may include in his report or certificate a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in his report or certificate.

8.5.6 Reports and Certificates on Specified Accounts or Items of Financial Statements: The test of materiality which a reporting auditor uses in connection with special purpose reports

may be different, depending upon the circumstances, from the test he would use in connection with a general purpose report. For example, where he is required to express an opinion on specified accounts or items of financial statements, he may judge the materiality of an item solely in relation to such individual accounts or items rather than to the aggregate thereof or to the financial statements as a whole. A reporting auditor's examination of certain records for an audit report or certificate for special purpose may also be more intensive than the examination of the same records by the statutory auditor for the purpose of expressing an opinion on the general purpose financial statements as a whole. Certain accounts or items of financial statements are inter - related, e.g., sales and trade receivables, purchases and trade payables, fixed assets and depreciation, etc. Therefore, where the reporting auditor is required to examine and report upon or certify a specified account or items of financial statement, he may also need to examine the related accounts or items to discover the inconsistencies, if any, between these inter - related accounts or items.

8.5.7 Communication of Report or Certificate: The reporting auditor may address his report or certificate to the client or to the public authority or person requiring it, as the case may be. In appropriate circumstances, a certificate may be issued without reference to any particular person or authority by using the words. 'To whomsoever it may concern'. The report or certificate should normally be issued to the client who should be responsible for forwarding the same to the connected authority, where so required.

8.5.8 Communication with the Previous Reporting Auditor: It should be a healthy tradition if the practice of communicating with the member who had done the work previously is followed in every case where a member is required to give a report or certificate for a special purpose.

8.6 Reporting Requirements in case of Comparative Information

SA 710 Comparative Information-Corresponding Figures and Comparative Financial Statements deals with auditor's responsibility regarding comparative information in an audit of financial statement. There are two different broad approaches to the auditor's responsibilities in respect of comparative information: Corresponding figures and Comparative financial statement.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

The objectives of the auditor are to obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and to report in accordance with the auditor's reporting responsibilities.

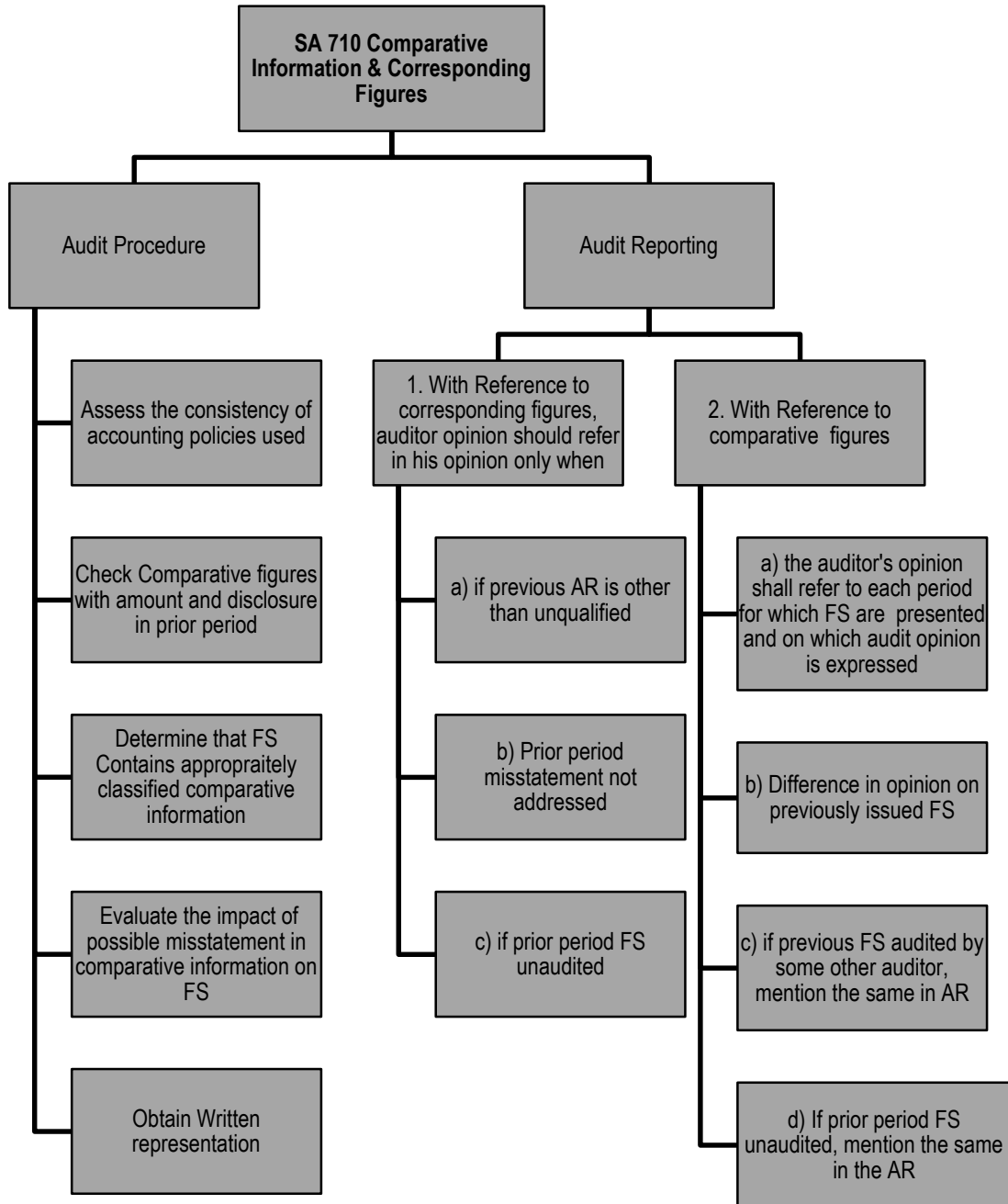
8.6.1 Audit Procedures for Comparative Information:

- (a) **Perform Specific audit Procedure:** For determining that the financial statement contains appropriately classified comparative information, the auditor should:

- Ensure that comparative information agrees with the amount and other disclosure presented in the prior period.
 - The accounting policies applied are consistent with those applied in current period.
 - If there have been any changes in the application of accounting policies than they are properly disclosed and presented.
- (b) **Evaluating the impact on financial statement:** If the auditor becomes aware of any possible misstatement in the comparative information, then:
- He should perform the necessary audit procedures to obtain sufficient audit evidence.
 - If the auditor had audited the prior period's financial statement than he should follow the relevant requirements of SA 560.
- (c) **Written Representation:** As required by SA 580, the auditor should also request written representation. He should also obtain a specific written representation regarding any prior period item that is disclosed in current year's financial statement.

8.6.2 Audit Reporting

- (a) **With Reference to Corresponding Figures:** When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:
- If the auditor's report of the previous period contains other than an unqualified opinion.
 - If the auditor is of the opinion, and he has sufficient evidence in this regard, that a material misstatement exists in the financial statement of prior period, which was not addressed earlier.
 - If the prior period financial statement are not audited, than he should obtain sufficient audit evidence that the opening balance does not contain any material misstatement.
- (b) **With Reference to Comparative Financial Statement:** When comparative financial statement are presented -
- The auditor's opinion shall refer to each period for which the financial statements are presented.
 - When reporting on current period's audit, if the auditor's opinion on such prior period financial statement differs from the opinion previously issued on such financial statement, the auditor shall disclose the substantive reason for the different opinion in other matter paragraph in his report.
 - If the auditor concludes that a material misstatement is present in the previously audited figures of financial statement, he should report it to the appropriate level of the management and request that the predecessor auditor be informed. If then the prior years statements are amended with new report by the predecessor auditor, then the auditor shall report only on the current period.



(c) Reporting treatment common to both (for corresponding figures and comparative information):

(i) If the financial statement of the prior period were audited by a predecessor auditor, the auditor (is permitted by law or regulation to refer to the predecessor audit report – on case of corresponding figures and decides to do so) shall state in his audit report:

- That the financial statement of the prior period were audited by a predecessor auditor;
- The type of the opinion expressed by the predecessor auditor;
- The date of that audit report.

(ii) If the prior period financial statement were not audited than he shall report the same in other matter paragraph in his audit report that the corresponding/comparative figures are unaudited. However, the disclosure does not relieve him from his responsibility of obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

(Note: Students are advised to refer Series of SA 700 on Audit Reporting and Conclusion in addition to SA 800 Series for better understanding)

Appendix 1

Comprehensive Format on the Audit Report:

Independent Auditor's Report

To the Members of ABC Limited

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (statement of changes in equity) and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)].

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Basis of our opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in Section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation and presentation of these

standalone financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these standalone financial statements based on our audit.

We have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the

Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the Company's Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the standalone financial statements.

Report on Other Legal and Regulatory Requirements

- 1. As required by the Companies (Auditor's Report) Order, 2016 ("the Order") issued by the Central Government of India in terms of sub-section (11) of section 143 of the Act, we give in the Annexure A, a statement on the matters specified in the paragraph 3 and 4 of the order.*
- 2. As required by Section 143 (3) of the Act, we report that:*

- (a) *we have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.*
- (b) *in our opinion proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books;*
- (c) *the balance sheet, the statement of profit and loss and the cash flow statement dealt with by this Report are in agreement with the books of account;*
- (d) *in our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014;*
- (e) *on the basis of the written representations received from the directors as on 31st March 2016 taken on record by the Board of Directors, none of the directors is disqualified as on 31 March 2016 from being appointed as a director in terms of Section 164 (2) of the Act;*
- (f) *with respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate report in “Annexure B”; and*
- (g) *with respect to the other matters to be included in the Auditor’s Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:*
 - i. *the Company has disclosed the impact of pending litigations on its financial position in its financial statements.*
 - ii. *the Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts.*
 - iii. *There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.*

For XYZ LLP

Chartered Accountants

Firm’s registration number:

Partner

Membership number:

Mumbai

18 April 2016

Annexure - A to the Auditors' Report

The Annexure referred to in Independent Auditors' Report to the members of the Company on the standalone financial statements for the year ended 31 March 2016, we report that:

- (i) (a) *The Company has maintained proper records showing full particulars, including quantitative details and situation of fixed assets*
- (b) *The Company has a regular programme of physical verification of its fixed assets by which fixed assets are verified in a phased manner over a period of three years. In accordance with this programme, certain fixed assets were verified during the year and no material discrepancies were noticed on such verification. In our opinion, this periodicity of physical verification is reasonable having regard to the size of the Company and the nature of its assets.*
- (c) *According to the information and explanations given to us and on the basis of our examination of the records of the Company, the title deeds of immovable properties are held in the name of the Company.*
- (ii) *The Company is a service company, primarily rendering software services. Accordingly, it does not hold any physical inventories. Thus, paragraph 3(ii) of the Order is not applicable to the Company.*
- (iii) *The Company has granted loans to five bodies corporate covered in the register maintained under section 189 of the Companies Act, 2013 ('the Act').*
 - (a) *In our opinion, the rate of interest and other terms and conditions on which the loans had been granted to the bodies corporate listed in the register maintained under Section 189 of the Act were not, prima facie, prejudicial to the interest of the Company*
 - (b) *In the case of the loans granted to the bodies corporate listed in the register maintained under section 189 of the Act, the borrowers have been regular in the payment of the principal and interest as stipulated.*
 - (c) *There are no overdue amounts in respect of the loan granted to a body corporate listed in the register maintained under section 189 of the Act.*
- (iv) *In our opinion and according to the information and explanations given to us, the Company has complied with the provisions of section 185 and 186 of the Act, with respect to the loans and investments made.*
- (v) *The Company has not accepted any deposits from the public.*
- (vi) *The Central Government has not prescribed the maintenance of cost records under section 148(1) of the Act, for any of the services rendered by the Company.*
- (vii) (a) *According to the information and explanations given to us and on the basis of our examination of the records of the Company, amounts deducted/ accrued in the books of account in respect of undisputed statutory dues including provident fund, income-tax, sales tax, value added tax, duty of customs, service tax, cess and other*

material statutory dues have been regularly deposited during the year by the Company with the appropriate authorities. As explained to us, the Company did not have any dues on account of employees' state insurance and duty of excise.

According to the information and explanations given to us, no undisputed amounts payable in respect of provident fund, income tax, sales tax, value added tax, duty of customs, service tax, cess and other material statutory dues were in arrears as at 31 March 2016 for a period of more than six months from the date they became payable.

- (b) *According to the information and explanations given to us, there are no material dues of duty of customs which have not been deposited with the appropriate authorities on account of any dispute. However, according to information and explanations given to us, the following dues of income tax, sales tax, duty of excise, service tax and value added tax have not been deposited by the Company on account of disputes:*

Name of the statute	Nature of dues	Amount (in Rs)	Period to which the amount relates	Forum where dispute is pending

- (viii) *The Company does not have any loans or borrowings from any financial institution, banks, government or debenture holders during the year. Accordingly, paragraph 3(viii) of the Order is not applicable.*
- (ix) *The Company did not raise any money by way of initial public offer or further public offer (including debt instruments) and term loans during the year. Accordingly, paragraph 3 (ix) of the Order is not applicable.*
- (x) *According to the information and explanations given to us, no material fraud by the Company or on the Company by its officers or employees has been noticed or reported during the course of our audit.*
- (xi) *According to the information and explanations give to us and based on our examination of the records of the Company, the Company has paid/provided for managerial remuneration in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Act.*
- (xii) *In our opinion and according to the information and explanations given to us, the Company is not a nidhi company. Accordingly, paragraph 3(xii) of the Order is not applicable.*

- (xiii) According to the information and explanations given to us and based on our examination of the records of the Company, transactions with the related parties are in compliance with sections 177 and 188 of the Act where applicable and details of such transactions have been disclosed in the financial statements as required by the applicable accounting standards.
- (xiv) According to the information and explanations give to us and based on our examination of the records of the Company, the Company has not made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year.
- (xv) According to the information and explanations given to us and based on our examination of the records of the Company, the Company has not entered into non-cash transactions with directors or persons connected with him. Accordingly, paragraph 3(xv) of the Order is not applicable.
- (xvi) The Company is not required to be registered under section 45-IA of the Reserve Bank of India Act 1934.

For XYZ LLP

Chartered Accountants

Firm's registration number:

Partner

Membership number:

Mumbai

18 April 2017

Annexure - B to the Auditors' Report

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 ("the Act")

We have audited the internal financial controls over financial reporting of ABC Limited ("the Company") as of 31 March 2016 in conjunction with our audit of the standalone financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

The Company's management is responsible for establishing and maintaining internal financial controls based on the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the Institute of Chartered Accountants of India ('ICAI'). These responsibilities include the design,

implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditors' Responsibility

Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on our audit. We conducted our audit in accordance with the Guidance Note on Audit of Internal Financial Controls over Financial Reporting (the "Guidance Note") and the Standards on

Auditing, issued by ICAI and deemed to be prescribed under section 143(10) of the Companies Act, 2013, to the extent applicable to an audit of internal financial controls, both applicable to an audit of Internal Financial Controls and, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance Note require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the Company's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that

(1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding

prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

In our opinion, the Company has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at 31 March 2016, based on the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India.

For XYZ LLP

Chartered Accountants

Firm's Registration Number:

Partner

Membership Number:

Mumbai

18 April 2017

Appendix 2

Comprehensive Case Studies on CARO 2016

1. *Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability? [Paragraph 3(xii)]*

Ans.

Relevant Provisions

- (a) *This clause requires the auditor to report whether, in the case of a Nidhi Company, net-owned funds to deposit liability ratio is more than 1:20 and the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules 2014 to meet out the liability.*
- (b) *Section 406(1) of the Act defines “Nidhi” to mean a company which has been incorporated as a Nidhi with the object of cultivating the habit of thrift and savings amongst its members, receiving deposits from, and lending to, its members only, for their mutual benefit, and which complies with such rules as are prescribed by the Central Government for regulation of such class of companies.*
- (c) *It may be noted that Ministry of Corporate Affairs on 31st March 2014, vide its Notification No. GSR 258(E) notified the ‘Nidhi Rules 2014’, which came into force on the first day of April 2014. These Rules apply to Nidhi company incorporated as a Nidhi pursuant to the provisions of Section 406 of the Act and also to the Nidhi companies declared under sub-section (1) of section 620A of the Companies Act 1956.*

Audit Procedures and Reporting

- (d) *It may be noted that Rule 5(1) prescribes the requirements for minimum number of members, net owned fund etc. As per Rule 5(1) every Nidhi shall, within a period of one year from the commencement of these rules, ensure that it has— (i) not less than two hundred members; (ii) net owned funds of ten lakh rupees or more; (iii) unencumbered term deposits of not less than ten per cent of the outstanding deposits as specified in Rule 14; and (iv) ratio of net owned funds to deposits of not more than 1:20. The auditor should note that as such a Nidhi Company can accept deposits not exceeding twenty times of its net owned funds as per last audited balance sheet. Furthermore, as per Rule 14, every Nidhi is to invest and continue to keep invested, in encumbered term deposits with a Scheduled commercial bank (other than a co-operative bank or a regional rural bank), or post office deposits in its own name an amount which shall not be less than ten per cent of the deposits outstanding at the close of business on the last working day of the second preceding month, which needs to be examined.*
- (e) *As per Rule 3(d) Net Owned Funds are defined as the aggregate of paid up equity share capital and free reserves as reduced by accumulated losses and intangible assets*

appearing in the last audited balance sheet: Provided that, the amount representing the proceeds of issue of preference shares, shall not be included for calculating Net Owned Funds.

- (f) *(A Nidhi company can accept fixed deposits, recurring deposits accounts and savings deposits from its members in accordance with the directions notified by the Central Government. The aggregate of such deposits is referred to as “deposit liability”.*
- (g) *The auditor should ask the management to provide the computation of the deposit liability and net owned funds on the basis of the requirements contained herein above. This would enable him to verify that the ratio of deposit liability to net owned funds is in accordance with the requirements prescribed in this regard. The auditor should verify the ratio using the figures of net owned funds and deposit liability computed in accordance with what is stated above. The comments of the auditor should be based upon such a statement provided by the management and verification of the same by the auditor.*
- (h) *The auditor may report, incorporating the following as at the balance sheet date:- (i) In case of shortfall in the ratio of net owned funds to the deposits, report the amount of shortfall and state the actual ratio of net owned funds to the deposits. (ii) In case of shortfall with regard to the minimum amount of 10% as unencumbered term deposits, as specified in Nidhi Rules 2014, report the amount thereof.*
2. *Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated? [Paragraph 3(x)]*

Ans.

Relevant Provisions

- (a) *This clause requires the auditor to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover such frauds. The scope of auditor’s inquiry under this clause is restricted to frauds ‘noticed or reported’ during the year. The use of the words “noticed or reported” indicates that the management of the company should have the knowledge about the frauds by the company or on the company by its Officer and employees that have occurred during the period covered by the auditor’s report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor’s comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, “The Auditor’s Responsibility Relating to Fraud in an Audit of Financial Statements”. In this*

context, the auditor should also have regard to the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013, issued by ICAI.

- (b) The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees including officers of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the "management fraud" can be construed as "fraud by the company".*
- (c) Two types of intentional misstatements are relevant to the auditor's consideration of fraud - misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.*
- (d) Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve: (i) Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared. (ii) Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information. (iii) Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.*
- (e) Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.*
- (f) Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system. Audit Procedures and Reporting*

Audit Procedures and Reporting

- (g) *While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.*
- (h) *The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.*
- (i) *The auditor should obtain written representations from management that: (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error; (ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation; (iii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and (iv) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.*
- (j) *Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."*
- (k) *The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government*

or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

- (l) *Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following: (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered. (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds. (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.*
3. *Whether the company has entered into any noncash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with? [Paragraph 3(xv)]*

Ans.

Relevant Provisions:

- (a) *Section 192 of the Act deals with restriction on noncash transactions involving directors or persons connected with them. The section prohibits the company from entering into following types of arrangements unless it meets the conditions laid out in the said section:*
- i. An arrangement by which a director of the company or its holding, subsidiary or associate company or a person connected with such director acquires or is to acquire assets for consideration other than cash, from the company.*
 - ii. An arrangement by which the company acquires or is to acquire assets for consideration other than cash, from such director or person so connected.*
- (b) *Arrangements, as discussed herein above, can only be entered by the company on fulfillment of the conditions laid out in Section 192 of the Act which are as under:*
- I. The company should have obtained prior approval for such arrangement through a resolution of the company in general meeting.*
 - II. In case the concerned director or the person connected therewith, is also a director of its holding company, a similar approval should have been obtained by the holding company through a resolution at its general meeting.*
- (c) *The reporting requirements under this clause are in two parts. The first part requires the auditor to report on whether the company has entered into any non-cash transactions with the directors or any persons connected with such director/s. The second part of the clause requires the auditor to report whether the provisions of section 192 of the Act*

have been complied with. Therefore, the second part of the clause becomes reportable only if the answer to the first part is in affirmative.

- (d) In other words, such transactions involving change in the assets or liabilities of a company but not involving “cash” or cash equivalents” as defined under Accounting Standard (AS) 3, “Cash Flow Statement” may be construed as non-cash transactions. At this point, it may be appropriate to also refer to the definition and discussion on “non-cash transactions” & “cash and cash equivalents”, as given in AS 3.
- (e) There may be a situation where the acquisition of the asset takes place in one year and the corresponding liability is created in the financial statements, the corresponding settlement in the following year. The said transaction will not be considered as non-cash transaction. Further, mergers under Court schemes would be entered into subject to requisite approvals of Court etc., would not be considered non-cash transactions.
- (f) The term “person connected with the director” has not been defined in the Act, or the Rules thereunder. Instead, the term “to any other person in whom the director is interested” is defined in the Explanation to sub section
- (1) of section 185 of the Act, which is reproduced as under and may be used as the reference point for reporting under this clause.
- “(a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;
- (b) any firm in which any such director or relative is a partner;
- (c) any private company of which any such director is a director or member;
- (d) any body corporate at a general meeting of which not less than twenty-five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or (e) any body corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.”
- (g) Section 2(77) of the Companies Act, 2013 read with Rule 4 of the Companies (Specification of Definition Details) Rules, 2014 defines the term “relative”. As per the aforesaid section 2(77), “Relative, with reference to any person, means anyone who is related to another, if –
- (i) they are members of a Hindu Undivided Family;
- (ii) they are husband and wife; or
- (iii) one person is related to the other in such manner as may be prescribed” As per Rule 4 of the Companies (Specification of Definition Details) Rules, 2014, a person shall be deemed to be the relative of another, if he or she is related to another in the following manner, namely –
- (i) Father, including step father

- (ii) *Mother, including step mother*
 - (iii) *Son, including step son*
 - (iv) *Son's wife*
 - (v) *Daughter*
 - (vi) *Daughter's husband*
 - (ii) *Brother, including step brother*
 - (viii) *Sister, including step sister*
- (h) *The term "acquire" simply means to come into possession of something. A thing that cannot be sold cannot be acquired. Thus, an acquisition would necessarily involve existence of two parties and a transfer of rights and/or obligations in a thing. In the context of section 192 of the Act, this transfer is between the company and the director and/or a person connected with a director. Such "director" is not restricted to being a director of the concerned company, but extends to director of a holding company, subsidiary or associate of the company under question.*
- (i) *As provided in section 192, the acquisition by/from the company has to be that of an "asset". Further, the term assets should be construed to have the same meaning as described in the Framework for Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India. The auditor would need to evaluate whether the subject matter of acquisition by/ from the company satisfies the characteristic of an "asset".*

Audit Procedures and Reporting

- (j) *For reporting on the first leg of the reporting clause, the starting point of the auditor's procedures could be obtaining a management representation as to whether the company has undertaken any non-cash transactions with the directors or persons connected with the directors, as envisaged in section 192(1) of the Act. The auditor would need to corroborate the management representation with sufficient appropriate audit evidence. A scrutiny of the following books of account, records and documents could provide source of such audit evidence to the auditor as to the existence of such non cash transactions as well as persons connected with the Directors:*

<i>Persons connected with Director</i>	<i>Acquisition by/ From Company</i>
<i>Form No. MBP 1, Notice of Interest by Director, filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014 [Ref: Sec 184(1) and Rule 9(1)]</i>	<i>Form No. MBP 2, Register of Loans, Guarantee, Security and Acquisition Made by the Company, filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014 [Ref: Sec 186(9) and Rule 12(1)]</i>
	<i>Form No. MBP 4, Register of Contracts with Related Party and Contracts and</i>

	<i>Bodies etc. in which Directors are Interested, filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014 [Ref: Sec 189(1) and Rule 16(1)]</i>
	<i>Movements in the Fixed Asset Register</i>
	<i>Minutes book of the General Meeting and Meetings of Directors</i>
	<i>Report on Annual General Meeting pursuant to Companies (Management and Administration) Rules, 2014 {Ref Sec 121(1) and Rule 31(2)}</i>

- (k) *The above documents and records would provide evidence of any such non-cash transactions that have actually taken place. The language of section 192(1) also uses the term “is to acquire” in the context of such transactions, indicating the existence of intention to acquire. The management may be requested to provide details of its intention to enter into transactions covered under section 192, after the date of the financial statements under audit. The minutes of the meetings of the Board of Directors and the Audit Committee may provide evidence of such intention. Besides, a scrutiny of the information for subsequent period as contained in the aforesaid records and documents may provide corroborative audit evidence of such intention having existed as at the date of the auditor’s report.*
- (l) *Where the company has entered into/is to enter into any non-cash transactions as discussed above, the auditor would make a report to that effect under this clause. The second leg of the clause requires the auditor to report whether the Company has complied with the provisions of section 192 in this regard. Section 192(1) and (2) envisage the following compliances in respect of such transactions:*
- (i) *The company should have obtained a prior approval for such arrangement by a resolution in the General Meeting.*
 - (ii) *If the concerned Director or connected person is a director of the company’s holding company, the latter too should have obtained a similar prior approval for the arrangement by a resolution at its General Meeting.*
 - (iii) *Notice for approval of the resolution should contain details of the arrangement along with the value of assets involved duly calculated by a registered valuer. The auditor should check compliance with Section 192(2) and verify the notice of the General Meeting that it includes particulars of arrangement along with the value of the assets involved such arrangements. The said value should be calculated by the register valuer.*

- (m) *In case where the concerned director/connected person is also a director of the holding company, the auditor would need to check whether the holding company has complied with the requirements. For this purpose, the auditor would need to obtain a management representation letter from the holding company through the management of the auditee company.*

Suggested paragraph on reporting:

According to the information and explanations given to us, the Company has entered into non-cash transactions with one of the directors/ person connected with the director during the year, by the acquisition of assets by assuming directly related liabilities, which in our opinion is covered under the provisions of Section 192 of the Act, and for which approval has not yet been obtained in a general meeting of the Company.

Appendix 3**Key Aspects discussed in Guidance Note on Reporting of Fraud under section 143(12) of the Companies Act 2013****1. What is Duty to report on frauds under Companies Act?**

As per sub-section (12) of section 143 of the Companies Act, 2013,

- if an auditor of a company
- in the course of the performance of his duties as auditor,
- has reason to believe that
- an offence of fraud involving such amount or amounts as may be prescribed,
- is being or has been committed in the company
- by its officers or employees,
- the auditor shall report the matter to the Central Government
- within such time and in such manner as may be prescribed.

2. What is the monetary threshold prescribed for such reporting?

Case-1 Fraud amounting to 1 crore or more:- If auditor has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (a) **the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;**
- (b) **on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;**
- (c) **in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;**
- (d) **the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;**
- (e) **the report shall be on the letter-head of the auditor containing postal address, e-mail**

address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

Case 2 Fraud amounting to less than 1 Crore.:- *Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.*

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

- (a) Nature of Fraud with description;*
- (b) Approximate amount involved; and*
- (c) Parties involved.*

3. What are disclosure requirements of FRAUD in Board's report?

Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that the

- companies, whose auditors have reported frauds under this sub-section (12)*
- to the audit committee or the Board,*
- but not reported to the Central Government,*
- shall disclose the details about such frauds in the Board's report*
- in such manner as may be prescribed.*

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

- (a) Nature of Fraud with description;*
- (b) Approximate Amount involved;*
- (c) Parties involved, if remedial action not taken; and*
- (d) Remedial actions taken.*

Appendix 4**Key Aspects discussed in Guidance Note on Reporting under Section 143(3) (f) and (h) of the Companies Act, 2013**

1. What are the reporting requirements under section 143(3)(f) and (h) of the Companies Act, 2013?

According to Section 143 (3) lays down certain matters required to be reported upon by the auditor in his report. Sub-section (3) of section 143 of Act provides as follows:

"(3) The auditor's report shall also state -

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;**
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;**
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;**
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;**
- (e) whether, in his opinion, the financial statements comply with the accounting standards;**
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;**
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;**
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;**
- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;**
- (j) such other matters as may be prescribed.**

2. What should be considered while reporting under clause (f) of subsection 3 of section 143:- "the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company"?

- *According to the Guidance note:- The words “observations” or “comments” as appearing in clause (f) of section 143(3) are construed to have the same meaning as referring to “emphasis of matter paragraphs, situations leading to modification in the auditor’s report. Accordingly, the auditor should have made an “observation” or “comment” in the auditor’s report in order to determine the need to report under clause (f) of section 143(3). Therefore, only such “observations” or “comments” of the auditors on financial transactions or matters that have been made by the auditor in the auditor’s report which have an adverse effect on the functioning of the company are required to be reported under this clause.*
- *It should be noted that there is no change in the objective and scope of an audit of financial statements because of inclusion of clause (f) in sub-section (3) of section 143 of the Act.*

3. Whether every qualification, disclaimer, adverse opinion, or emphasis of matter para required to be included in above reporting?

According to this Guidance Note - The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate the subject matters leading to modification of the audit report or emphasis of matter in the auditor’s report to make judgment as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters which, in the opinion of the auditor, have an adverse effect on the functioning of the company should be reported under this clause. Hence such qualifications or adverse opinions or disclaimer of opinion or emphasis of matters of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be reported under this clause.

4. Illustrate which type of modifications in auditor’s report will require to report under 143(3)(f) and which are not?

Examples of emphasis of matter which may have an adverse effect on the functioning of the company include situations where:

- *The going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company’s ability to continue as a going concern; or*
- *a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.*

Examples of emphasis of matter which may not have an adverse effect on the functioning of the company include a situation where there is an emphasis of matter:

- *on managerial remuneration which is subject to the approval of the Central Government;*
- *relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;*

- *on frauds that have been dealt with in the financial statements of the company and would not have any continuing effect on the financial statements*

5. What is scope of auditor while reporting under 143(3)(h) “any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith”?

According to Guidance Note, the words “qualification”, “adverse remark” and “reservation” used in clause (h) of section 143(3) should be considered to be similar to the terms “qualified opinion”, “adverse opinion” and “disclaimer of opinion”, respectively, referred to in SA 705 “Modifications to the Opinion in the Independent Auditor’s Report”. Hence, the auditor would need to report under clause (h) of section 143(3) any matter that causes a qualification, adverse remark or disclaimer of opinion on the financial statements since such matters will or possibly will have an effect on the books of account maintained by the company. It should be noted that the auditor may have made an observation on maintenance of cost records under clause (b) of section 143(3) and this may not have had an effect on the financial statements of the company or the auditor’s opinion on the financial statements. Further, any material weakness in internal financial controls that is reported by the auditor under clause (i) of section 143(3) may not have an impact on the maintenance of books of account if such material weakness did not result in a modification to the opinion on the financial statements of the company. However, if the material weakness in internal financial controls resulted in a modification to the audit opinion on the financial statements, then such modification may be covered for reporting under clause (h) of section 143(3).

Appendix 5

Key Aspects discussed in Guidance Note on Internal Financial Control over Financial Reporting

1. What is Internal Financial Control (IFC)? (Sec 134)

As per Section 134 of the Companies Act 2013, the term Internal Financial Controls means the policies and procedures adopted by the company for ensuring:

- Orderly and efficient conduct of its business, including adherence to Company's policies,
- Safeguarding of its assets,
- Prevention and detection of frauds and errors,
- Accuracy and completeness of the accounting records, and
- Timely preparation of reliable financial information.

2. What is Internal Controls over financial Reporting (ICFR)?

As per Guidance Note issued by ICAI on Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (September, 2015), "Internal Financial Controls Over Financial Reporting (ICFR) shall mean:

"A Process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles". A Company's internal financial control over financial reporting includes those policies and procedures:

Pertain to the maintenance of the records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company:

It provides reasonable assurance that transactions are recorded as necessary to permit preparation of financial statement in accordance with generally accepted accounting principles, and those receipts and expenditures of the company are being made only in accordance with authorizations of management and director of the company.

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effects of the financial statement.

3. Which provision of Companies Act requires such IFC and Reporting? Section 134:

In the case of a listed company, the Directors' Responsibility states that directors, have laid down IFC to be followed by the company and that such controls are adequate and operating effectively.

Section 143:

The auditor's report should also state whether the company has adequate IFC system in place and the operating effectiveness of such controls

Section 177:

Audit committee may call for comments of auditors about internal control systems before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

Schedule IV

The independent directors should satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust and defensible.

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 –

The director's report should contain details in respect of adequacy of internal financial controls with reference to the financial reporting.

4. To whom does this apply?

The guidance note clarifies that reporting on ICFR by auditors will be applicable to both listed and unlisted companies, including small and one person companies. This is in line with the requirements of section 143(3)(i) of the Companies Act, 2013.

Furthermore, it states that auditors will have to report on ICFR in respect of both stand alone and consolidated financial statements.

5. When does this apply and for financial statements of which period?

The guidance note clarifies that auditors will have to report whether a company has an adequate ICFR system in place and whether the same was operating effectively as at the balance sheet date of 31 March 2016. In practice, this will mean that when forming its audit opinion on ICFR, the auditor will surely test transactions during the financial year ending 31 March 2016 and not just as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher. If control issues or deficiencies are identified during the interim period and are remediated before the balance sheet date, then the auditor may still be able to express an unqualified opinion on the ICFR. This is particularly important for companies for the current year ending 31 March 2016, as it will be the first year when auditor validation of ICFR will be required.

6. What is extent of reporting?

The auditor needs to obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

9

Audit Committee and Corporate Governance

9.1 Introduction

Corporate Governance is the system by which companies are directed and governed by the management. Through use of ethical business processes, the management is able to ensure accountability, transparency and fairness in the company operations, thereby ensuring that the interests of shareholders and all other stakeholders are protected. The Board of Directors are responsible for governance of their companies.

9.2 Corporate Governance



The word 'Corporate' relates to a large business entity or a large company. Similarly, the word 'Governance' means exercise of authority, direction or control. Thus, the concept of 'Corporate Governance' is the system by which the management of a business entity directs and controls the activities in the best interest of the stakeholders. Issues addressed in the LODR (Listing Obligations and Disclosure Requirements) Regulations regarding corporate governance are discussed in 9.3.1.

*Fig.: What is Corporate Governance?**

9.3 The Legal Framework

The Securities and Exchange Board of India (SEBI) issued circular no. CIR/CFD/POLICY CELL/2/2014 dated April 17, 2014 to all recognised stock exchanges, making amendments to Clause 35B and Clause 49 of the Equity Listing Agreement, with the intent to align the Listing Agreement with the provisions of the Companies Act, 2013, to make the corporate governance framework more effective and to adopt best practices on corporate governance. Further amendments were made to Clause 49 of the Listing Agreement vide circular no. CIR/CFD/POLICY CELL/7/2014 dated September 15, 2014.

** Source : mark wignall*

Since a listing agreement is a statutorily mandated contract between the listed entity and the stock exchange where it is listed, it does not have the authority of law behind it. Hence, on September 2, 2015, SEBI issued the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR Regulations"), with the objective of streamlining and consolidating the provisions of various listing agreements in operation for different segments of the capital markets, such as equity shares, preference shares, debt instruments, units of mutual funds, Indian depository receipts, securitised debt instruments and any other securities that the SEBI may specify.

The LODR Regulations are divided into two parts - the substantive provisions are incorporated in the main body while the procedural requirements are incorporated in the form of schedules. The LODR Regulations also capture the corporate governance principles found in Clause 49 of SEBI's Model Listing Agreement. It may be noted that the LODR Regulations deal with only post-listing requirements and exclude all pre-listing requirements. Needless to add, the above-mentioned circulars stand rescinded.

Certain amendments to the LODR Regulations have been made vide SEBI (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2016, w.e.f. April 1, 2016. The LODR Regulations and the amendments made thereto are collectively referred to as LODR Regulations hereinbelow.

9.3.1 Issues of Corporate Governance

Issues addressed in the LODR Regulations regarding corporate governance are:

- (i) Responsibilities and key functions of the Board, its composition, compensation and disclosures;
- (ii) Code of Conduct and vigil mechanism;
- (iii) Composition, meetings, powers, role and responsibilities of the Audit Committee which is an important pillar of corporate governance;
- (iv) Management of subsidiary companies;
- (v) Procedures related to risk management;
- (vi) Disclosures on important issues regarding related party transactions, accounting treatment, etc.;
- (vii) Content of management discussion and analysis;
- (viii) Information to shareholders;
- (ix) Compliance Certificate by the CEO and CFO;
- (x) Compliance Certificate from either the auditors or practising company secretaries regarding compliance of conditions on corporate governance.

9.3.2 Applicability of LODR Regulations [Regulation 3]

Unless otherwise provided, these regulations shall apply to the listed entity who has listed any of the following designated securities on recognised stock exchange(s):

9.3 Advanced Auditing and Professional Ethics

- (a) *specified securities listed on main board or SME Exchange or institutional trading platform;*
- (b) *non-convertible debt securities, non-convertible redeemable preference shares, perpetual debt instrument, perpetual non-cumulative preference shares;*
- (c) *Indian depository receipts;*
- (d) *securitised debt instruments;*
- (e) *units issued by mutual funds;*
- (f) *any other securities as may be specified by the Board.*

9.4 Audit Committee under LODR Regulations

The summarised requirements of corporate governance are discussed below:

9.4.1 Qualified and Independent Audit Committee [Regulation 18 (1)]

Every listed entity shall constitute a qualified and independent audit committee in accordance with the terms of reference, subject to the following:

1. *The Audit Committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.*
2. *All members of Audit Committee shall be financially literate and at least one member shall have accounting or related financial management expertise.*

Explanation (i): *The term “financially literate” means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.*

Explanation (ii): *A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.*

3. *The Chairperson of the Audit Committee shall be an independent director and he shall be present at Annual General Meeting to answer shareholder queries;*
4. *The Company Secretary shall act as the secretary to the committee.*
5. *The Audit Committee at its discretion shall invite the finance director or the head of the finance function, head of internal audit and a representative of the statutory auditor and any other such executives to be present at the meetings of the committee; provided that occasionally, the Audit Committee may meet without the presence of any executives of the listed entity.*

9.4.2 Meeting of Audit Committee [Regulation 18 (2)]

The Audit Committee shall meet at least four times in a year and not more than one hundred and twenty days shall lapse between two meetings. The quorum shall be either two members or one third of the members of the Audit Committee whichever is greater, but there should be a minimum of two independent directors present.

9.4.3 Powers of Audit Committee [Regulation 18 (2)]

The Audit Committee shall have powers, which should include the following:

- (1) To investigate any activity within its terms of reference.*
- (2) To seek information from any employee.*
- (3) To obtain outside legal or other professional advice.*
- (4) To secure attendance of outsiders with relevant expertise, if it considers necessary.*

It may be noted that the powers mentioned above are only illustrative and not exhaustive.

The auditor should check whether the terms of reference of the Audit Committee have been suitably framed mentioning the above powers. It is mandatory for the above-mentioned four powers to be vested in the Audit Committee. The Board may delegate/vest further powers to the committee.

9.4.4 Role of Audit Committee [Part C (A) of Schedule II]

The role of the Audit Committee shall include the following:

- 1. Oversight of the listed entity's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;*
- 2. Recommendation for appointment, remuneration and terms of appointment of auditors of the listed entity;*
- 3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors;*
- 4. Reviewing, with the management, the annual financial statements and auditor's report thereon before submission to the Board for approval, with particular reference to:*
 - (a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013;*

- (b) Changes, if any, in accounting policies and practices and reasons for the same;*
 - (c) Major accounting entries involving estimates based on the exercise of judgment by management;*
 - (d) Significant adjustments made in the financial statements arising out of audit findings;*
 - (e) Compliance with listing and other legal requirements relating to financial statements;*
 - (f) Disclosure of any related party transactions;*
 - (g) Modified opinion(s) in the draft audit report;*
- 5. Reviewing, with the management, the quarterly financial statements before submission to the Board for approval;*
 - 6. Reviewing, with the management, the statement of uses/application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document/prospectus/ notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;*
 - 7. Reviewing and monitoring the auditor's independence and performance, and effectiveness of audit process;*
 - 8. Approval or any subsequent modification of transactions of the listed entity with related parties;*
 - 9. Scrutiny of inter-corporate loans and investments;*
 - 10. Valuation of undertakings or assets of the listed entity, wherever it is necessary;*
 - 11. Evaluation of internal financial controls and risk management systems;*
 - 12. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;*
 - 13. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit;*
 - 14. Discussion with internal auditors of any significant findings and follow up there on;*
 - 15. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board;*

16. *Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern;*
17. *To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors;*
18. *To review the functioning of the Whistle Blower mechanism;*
19. *Approval of appointment of Chief Financial Officer after assessing the qualifications, experience and background, etc. of the candidate;*
20. *Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.*

If the company has set up an Audit Committee as per section 177 of the Companies Act, 2013, the company must ensure that the said Audit Committee has such additional functions / features as are contained in the LODR Regulations.

9.5 Audit Committee under Section 177 of the Companies Act, 2013

- (i) *As per section 177 read with Rule 6 of the Companies (Meetings of Board and its Powers) Rules, 2014, every listed company and the following classes of companies shall constitute an Audit Committee -*
 - (a) *all public companies with a paid up capital of ten crore rupees or more;*
 - (b) *all public companies having turnover of one hundred crore rupees or more;*
 - (c) *all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.*

Explanation- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

- (ii) *The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority. It may be noted that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement.*

9.6 Functions of the Audit Committee

The Audit Committee performs various important functions like investigating the matters referred by board, discuss about internal control system etc. These sub-

sections of Section 177 are reproduced hereunder which specify the terms of reference as well as functions of the Audit Committee:

Sub Section 4: “Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall inter alia, include,—

- (i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;
- (ii) review and monitor the auditor’s independence and performance, and effectiveness of audit process;
- (iii) examination of the financial statement and the auditors’ report thereon;
- (iv) approval or any subsequent modification of transactions of the company with related parties;

However, the Audit Committee may make omnibus approval for related party transactions proposed to be entered into by the company subject to such conditions as may be prescribed.

- (v) scrutiny of inter-corporate loans and investments;
- (vi) valuation of undertakings or assets of the company, wherever it is necessary;
- (vii) evaluation of internal financial controls and risk management systems;
- (viii) monitoring the end use of funds raised through public offers and related matters.”

Sub Section 5: “The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.”

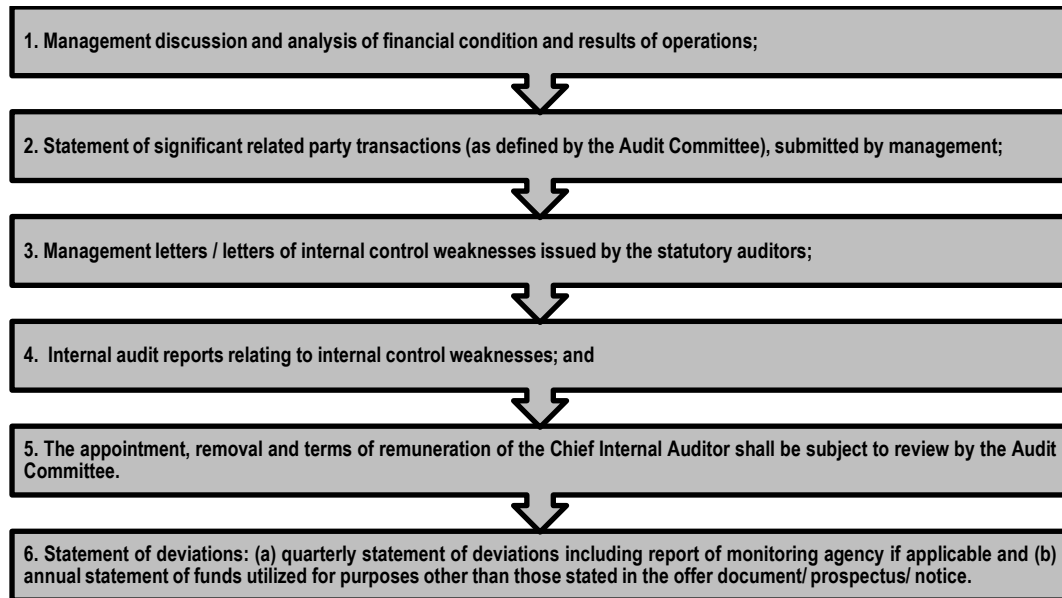
Sub Section 6: “The Audit Committee shall have authority to investigate into any matter in relation to the items specified in sub-section (4) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.”

Sub Section 9: “Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.”

Sub Section 10: “The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases: Provided that the details of establishment of such mechanism shall be disclosed by the company on its website, if any, and in the Board’s report.”

9.7 Review of Information by Audit Committee

The Audit Committee shall mandatorily review the following information as per Part C (B) of Schedule II:



The auditor should ascertain from the minutes book of the Audit Committee and other sources like agenda papers, etc. whether the Audit Committee has reviewed the above-mentioned information. The auditor should ascertain whether as a part of Directors' Report or as an addition thereto, a Management Discussion and Analysis report forms part of the annual report to the shareholders. The auditor should further ascertain whether the Management Discussion and Analysis report includes discussion on the matters stipulated in Schedule V (B).

Where certain deficiencies or adverse findings are noted by the Audit Committee, the auditor will be required to see that these have been suitably dealt with by the management in the report on corporate governance.

The auditor should ascertain that the information reviewed by the Audit Committee is consistent with the reporting in the financial statements including those drawn up giving segment wise break-up for compliance with Accounting Standard (AS) 17 (Segment Reporting)/ Indian Accounting Standard 108 (Operating Segments).

9.8 Role of Auditor in Audit Committee and Certification of Compliance of Conditions of Corporate Governance

The LODR Regulations as well as the Companies Act, 2013 in respect of the constitution of Audit Committee underline the importance of audit process and its contribution to the corporate governance process.

Regulation 18 (1) (f) stipulates that a representative of the statutory auditor, when required, shall be invited to the meetings of the Audit Committee. Similarly, Section 177 of the Companies Act, 2013 provides the auditors of a company and the key managerial personnel the right to be heard in the meetings of the Audit Committee when it considers the auditor's report but they shall not have the right to vote.

The auditor must ensure that he communicates frequently and openly with the Audit Committee on key accounting or auditing issues that, in the auditor's judgment, give rise to a greater risk of material misstatement of the financial statements, and also ensure that he addresses any questions or concerns voiced by the Audit Committee.

He can contribute significantly in assisting and advising the Audit Committee on improving corporate governance, oversight of financial reporting process, implementation of accounting policies and practices, compliance with accounting standards, strengthening of the internal control systems in regard to financial reporting and reporting processes.

The auditor must devote substantial professional time in assisting the management and the Audit Committee to enable them to discharge their functions effectively and in certification of the requirements of corporate governance.

The auditor has to keep in mind that his role is not to drive corporate governance directly. Rather, it is the management's responsibility to do so and, in the process, he should play a significant role in assisting management to ensure better standards of corporate governance.

9.8.1 Auditor's Responsibility - *The auditor's responsibility in certifying compliance with the requirements of corporate governance relates to the verification and certification of factual implementation of requirements of corporate governance as stipulated in the LODR Regulations. Such verification and certification is neither an audit nor an expression of opinion on the financial statements of the company.*

The certificate from the auditor as regards compliance with the requirements of corporate governance is neither an assurance as to the future viability of the company, nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

9.8.2 General Principles of Audit

The standards set out in the Standards on Auditing (hereinafter referred to as SA) would be applicable in the performance of certification with the requirements of corporate governance by the auditor, to the extent relevant.

As in the case of other professional assignments, in certifying the compliance with the requirements of corporate governance, the auditor should comply with the "Code of Ethics" issued by the Institute of Chartered Accountants of India (ICAI).

The auditor should conduct verification of compliance with the requirements of corporate governance as stipulated in the LODR Regulations, in accordance with the Guidance Note on Certification of Corporate Governance issued by ICAI.

9.8.3 Documentation

The auditor should document matters, which are important in providing evidence to support the certificate of factual findings, in accordance with SA 230 on “Audit Documentation”.

9.8.4 Management Representations

The auditor should consider obtaining management representations in accordance with SA 580, “Written Representations”.

9.8.5 Verification regarding Composition of Board [Regulation 17]

- (i) *The auditor should ascertain whether, throughout the reporting period, the Board of Directors comprises an optimum combination of executive and non-executive directors, with at least one woman director and not less than 50% of the Board of Directors comprising non-executive directors. The minutes of the Board of Directors’ meetings should be verified to ascertain whether a director is an executive director or a non-executive director.*
- (ii) *The auditor should also verify that where the Chairperson of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case the listed entity does not have a regular non-executive Chairperson, at least half of the Board of Directors should comprise independent directors. Further, if the regular non-executive Chairperson is a promoter of the listed entity or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, at least one-half of the Board of the listed entity shall consist of independent directors.*

In determining the number of requisite independent directors and/or non-executive directors, the fraction, if any, in the number of one-half or one-third as the case may be, should be rounded off. Since the terms in this clause refer to ‘not less than’ and ‘at least’, it would be appropriate to compute the number by rounding off any fraction to the next integer. For example, in a Board headed by a non-executive Chairman and comprising of six other directors (i.e., seven directors), the independent directors should be three or more.

- (iii) *Annual disclosure submitted by the directors to the Board of Directors may be examined for this purpose. If the Board of Directors has followed any particular procedure(s) to ascertain the independence of directors, the auditor should examine the same. Effect of changes in the composition of the Board and/or its Chairman and its impact on compliance throughout the reporting period should also be examined.*
- (iv) *An independent non-executive director, apart from receiving remuneration, should not have had/ should not have any material pecuniary relationship with the listed entity, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year. Also, such independent director, either by himself or with*

any of his relatives should not be a material supplier, service provider or customer or a lessor or lessee of the listed entity, and should not also be a substantial shareholder of the listed entity. In determining 'not a substantial shareholder', he (together with his relatives) should not own 2% or more of total voting power of the listed entity.

[Student may note that independent director means a non-executive director other than a nominee director of the listed entity (a) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience(b) who is or was not a promoter of the listed entity or its holding, subsidiary or associate company and who is not related to promoters or directors in the listed entity, its holding, subsidiary or associate company(c) apart from receiving director's remuneration, has or had no material pecuniary relationship with the listed entity, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year (d) none of whose relatives has or had pecuniary relationship or transaction with the listed entity, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year, (e) who, neither himself nor any of his relatives (i) holds or has held the position of a key managerial personnel or is or has been employee of the listed entity or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of (A) a firm of auditors or company secretaries in practice or cost auditors of the listed entity or its holding, subsidiary or associate company; or (B) any legal or a consulting firm that has or had any transaction with the listed entity, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;(iii) holds together with his relatives two per cent or more of the total voting power of the listed entity; or (iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts from the listed entity, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the listed entity (v) is a material supplier, service provider or customer or a lessor or lessee of the listed entity and (f) who is not less than 21 years of age.]

9.9 Remuneration of Directors [Part C of Schedule V]

Disclosure requirements regarding directors' remuneration are stated below:

- (i) **All pecuniary relationship or transactions of the non-executive directors vis-à-vis the listed entity shall be disclosed in the Annual Report.**

- (ii) *Criteria of making payments to non-executive directors. Alternatively, this may be disseminated on the listed entity's website and reference drawn thereto in the annual report;*
- (iii) *In addition to the disclosures required under the Companies Act, 2013, the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:*
 - (a) *All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.*
 - (b) *Details of fixed component and performance linked incentives, along with the performance criteria.*
 - (c) *Service contracts, notice period, severance fees.*
 - (d) *Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.*

9.9.1 Approval of Remuneration of Directors [Regulation 17 (6)]

All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, in any financial year and in aggregate.

The requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 2013 for payment of sitting fees without approval of the Central Government. Provided further that independent director shall not be entitled to any stock option.

In this context, the auditor should:

- 1. ascertain from the minutes of the Board of Directors' meetings, shareholders' meetings, relevant agenda papers, notices, explanatory statements etc., whether the remuneration of non- executive directors has been decided by the Board of Directors after receiving prior approval of the shareholders in the general meeting;*
- 2. refer to the Articles of Association of the company, wherever applicable;*
- 3. examine the Report of the Board of Directors on corporate governance to be included in the annual report of the company and ascertain whether the same contains the disclosures with respect to remuneration of directors and compensation to non-executive directors. The auditor should correlate this data with that contained in the financial statements.*

Where application of this clause requires the value of ESOP to be determined, the services of expert may have to be utilized. In this regard, reference may be made to SA 620 dealing with "Using the Work of an Auditor's Expert"

9.10 Obligations of Director and Senior Management [Regulations 17(2) to 17(4), 25(5) to 25(6), 26(1) to 26 (2), 26(4) to 26(5)]

- (i) *The Board shall meet at least four times a year, with a maximum time gap of one hundred and twenty days between any two meetings.*
- (ii) *A director shall not be a member in more than ten committees or act as Chairperson of more than five committees across all listed entities in which he is a director. Furthermore, every director shall inform the listed entity about the committee positions he occupies in other listed entities and notify changes as and when they take place.*

It may be noted that for the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 8 of the Companies Act, 2013 shall be excluded and for the purpose of reckoning the limit under this sub-clause, Chairpersonship/membership of the Audit Committee and the Stakeholders' Relationship Committee alone shall be considered.

- (iii) *The Board shall periodically review compliance reports of all laws applicable to the listed entity, prepared by the listed entity as well as steps taken by the listed entity to rectify instances of non-compliances.*
- (iv) *Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed entity in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.*
- (v) *An independent director shall be held liable, only in respect of such acts of omission or commission by the listed entity which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the LODR Regulations.*
- (vi) *Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)*
- (vii) *An independent director who resigns or is removed from the Board of Directors of the listed entity shall be replaced by a new independent director at the earliest but not later than the immediate next Board meeting or three months from the date of such vacancy, whichever is later.*

Provided that where the listed entity fulfils the requirement of independent directors in its Board even without filling the vacancy created by such resignation

or removal, as the case may be, the requirement of replacement by a new independent director shall not apply.

(viii) The Board of Directors of the listed entity shall satisfy itself that plans are in place for orderly succession for appointments to the Board and to senior management.

9.10.1 Section 173(1) of the Companies Act, 2013 provides

“Every company shall hold the first meeting of the Board of Directors within thirty days of the date of its incorporation and thereafter hold a minimum number of four meetings of its Board of Directors every year in such a manner that not more than one hundred and twenty days shall intervene between two consecutive meetings of the Board.

Provided that the Central Government may, by notification, direct that the provisions of this sub-section shall not apply in relation to any class or description of companies or shall apply subject to such exceptions, modifications or conditions as may be specified in the notification.

Both the LODR Regulations and Section 173 stipulate that Board meetings shall be held at least four times a year and that the maximum time gap between any two meetings should not exceed one hundred and twenty days.

The auditor should ascertain from the minute’s book of the Board meetings whether Board meetings were held at least four times a year, with a maximum time gap of one hundred and twenty days between any two meetings. The auditor should also ascertain whether the minimum required information was made available to the Board.

The auditor should also ascertain that a director of the company is not a member in more than ten committees or is acting as Chairman of more than five committees across all companies in which he is a director. A suitable declaration from director should be obtained to this effect. This information should be verified from the mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies as well as from the changes notified by the director as and when they take place.

For the purpose of reviewing compliance reports of all laws applicable to the company, the said reports prepared by the company as well as steps taken by the company to rectify instances of non-compliances, the auditor should take into consideration SA 250, dealing with “Consideration of Laws and Regulations in an Audit of Financial Statements”. It is the management’s responsibility to ensure that company operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with the management. The auditor’s responsibility is limited to verification that management has taken suitable steps and has put in place policies and procedures to ensure compliance with laws and regulations and to detect deviation from such procedures. The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects should be considered when preparing financial statements.

9.11 Code of Conduct [Regulations 17(5), 26(3), 46(2) and Part D of Schedule V] -

- (i) The Board shall lay down a code of conduct for all Board members and senior management of the listed entity.*
- (ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis.*
- (iii) The Code of Conduct shall suitably incorporate the duties of Independent Directors as laid down in the Companies Act, 2013.*
- (iv) The code of conduct shall be posted on the website of the company.*
- (v) The Annual Report of the company shall contain a declaration to this effect signed by the CEO.*

For this purpose, the term “senior management” shall mean personnel of the listed entity who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

The auditor should ascertain whether the Board of Directors of the company has laid down a Code of Conduct for all Board members and senior personnel of the company and obtain a copy of the same. He should also verify whether all Board members and senior management personnel have affirmed compliance with the code on an annual basis and whether the code has been posted on company’s website.

9.12 Vigil Mechanism [Regulations 22 and 46 and Part C of Schedule V]

- (i) The listed entity shall establish a vigil mechanism for directors and employees to report genuine concerns.*
- (ii) This mechanism should also provide for adequate safeguards against victimization of director(s) / employee(s) or any other person who avail the mechanism and also provide for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.*
- (iii) The details of establishment of such mechanism shall be disclosed by the company on its website and in the Board’s report.*

9.13 Subsidiary of Listed Entity [Regulations 16(c), 24 and 46 and Part C of Schedule V]

- (i) At least one independent director on the Board of Directors of the listed entity shall be a director on the Board of Directors of an unlisted material subsidiary, incorporated in India.*
- (ii) The Audit Committee of the listed entity shall also review the financial statements, in particular, the investments made by the unlisted subsidiary.*

- (iii) *The minutes of the Board meetings of the unlisted subsidiary shall be placed at the Board meeting of the listed entity. The management of the unlisted subsidiary shall periodically bring to the notice of the Board of Directors of the listed entity, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary.*
- (iv) *The company shall formulate a policy for determining ‘material’ subsidiaries and such policy shall be disclosed on the company’s website and a web link thereto shall be provided in the Annual Report.*
- (v) *For the purpose of this clause, a subsidiary shall be considered as material if the investment of the company in the subsidiary exceeds twenty per cent of its consolidated net worth as per the audited balance sheet of the previous financial year or if the subsidiary has generated twenty per cent of the consolidated income of the company during the previous financial year.*
- (vi) *A listed entity shall not dispose of shares in its material subsidiary resulting in reduction of its shareholding (either on its own or together with other subsidiaries) to less than 50% or cease the exercise of control over the subsidiary without passing a special resolution in its General Meeting except in cases where such divestment is made under a scheme of arrangement duly approved by a Court/Tribunal.*
- (vii) *Selling, disposing and leasing of assets amounting to more than twenty percent of the assets of the material subsidiary on an aggregate basis during a financial year shall require prior approval of shareholders by way of special resolution, unless the sale/disposal/lease is made under a scheme of arrangement duly approved by a Court/Tribunal.*

Explanation

- (i) *The term “material non-listed Indian subsidiary” shall mean an unlisted subsidiary, incorporated in India, whose income or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated income or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.*
- (ii) *The term “significant transaction or arrangement” shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.*
- (iii) *Where a listed entity has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.*

Regulation 24 requires the Audit Committee of the listed entity to review the financial statements and in particular, the investments made by the unlisted subsidiary. This is required in regard to all unlisted subsidiaries, without reference to materiality or place

of incorporation etc. Where however the subsidiary of a listed entity is itself a listed entity, Explanation (iii) above would apply.

9.14 Statement of Deviation(s) or Variation(s) [Regulation 32 and Part C of Schedule II]

- (1) *The listed entity shall submit to the stock exchange the following statement(s) on a quarterly basis for public issue, rights issue, preferential issue etc. :-*
 - (a) *Indicating deviations, if any, in the use of proceeds from the objects stated in the offer document or explanatory statement to the notice for the general meeting, as applicable;*
 - (b) *Indicating category-wise variation (capital expenditure, sales and marketing, working capital etc.) between projected utilisation of funds made by it in its offer document or explanatory statement to the notice for the general meeting, as applicable and the actual utilisation of funds.*
- (2) *The statement(s) shall be continued to be given till such time the issue proceeds have been fully utilised or the purpose for which these proceeds were raised has been achieved.*

The audit committee shall mandatorily review:

- (a) *Quarterly statement of deviation(s) including report of monitoring agency, if applicable, submitted to stock exchange(s) in terms of Regulation 32(1).*
- (b) *Annual statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice.*

9.15 Disclosures - Management Discussion and Analysis [Schedule V]

As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

- (a) *Industry structure and developments.*
- (b) *Opportunities and Threats.*
- (c) *Segment-wise or product-wise performance.*
- (d) *Outlook*
- (e) *Risks and concerns.*
- (f) *Internal control systems and their adequacy.*
- (g) *Discussion on financial performance with respect to operational performance.*
- (h) *Material developments in Human Resources / Industrial Relations front, including number of people employed.*

The above information presented by the management is likely to include non-financial information, which may be outside the auditor's area of expertise. In such situations, the auditor may keep in mind SA 315 relating to "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" and the fact that he is only required to review the compliance with disclosure requirements and not verify the particular facts as disclosed by the management.

The auditor should ascertain that the segment-wise or product-wise performance (sub-clause (i) (c) as stated above) is consistent with what is reported in financial statements complying with AS 17 (Segment Reporting)/ Indian Accounting Standard 108 (Operating Segments) and also as per provisions of Section 133, 134 and 143 of the Companies Act, 2013.

9.16 Information to Shareholders [Regulation 36]

In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

- (a) A brief resume of the director;*
- (b) Nature of his expertise in specific functional areas;*
- (c) Disclosure of relationships between directors inter-se;*
- (d) Names of listed entities in which the person also holds the directorship and the membership of Committees of the Board; and*
- (d) Shareholding of non-executive directors.*

The auditor should ascertain from the communications sent, whether in the case of appointment of a new director or re-appointment of a director, the shareholders have been provided with the information stipulated above.

9.17 Stakeholders Relationship Committee [Regulation 20 and Part D of Schedule II]

- (i) The listed entity shall constitute a Stakeholders Relationship Committee to specifically look into the mechanism of redressal of grievances of shareholders, debenture holders and other security holders.*
- (ii) The chairperson of this Committee shall be a non-executive director.*
- (iii) The Board of Directors shall decide other members of this Committee.*
- (iv) The Committee shall consider and resolve the grievances of the security holders of the listed entity including complaints related to transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends.*

The auditor should ascertain from the minutes book of the Board meetings whether a Board committee, namely a Shareholders/ Investors Grievance Committee has been set up under the chairmanship of a non-executive director to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of

balance sheet, non-receipt of declared dividends, etc. Further the auditor should also ascertain from the minutes book of the Shareholders/ Investors Grievance Committee meetings whether such committee is prima facie functioning.

The auditor should also verify from the records of the Shareholders/ Investors Grievance Committee as well as from the certificate obtained by the listed entity from SEBI and stock exchange(s), if any, as regards the investors' grievances pending up to the date of certificate of compliance of conditions of corporate governance.

9.18 Transfer or Transmission or Transposition of Securities [Regulation 40]

The Board of Directors of a listed entity shall delegate the power of transfer of securities to a committee or to the compliance officer or to the registrar to an issue and/or share transfer agents.

However, the board of directors and/or the delegated authority shall attend to the formalities pertaining to transfer of securities at least once in a fortnight. It may be noted that the delegated authority shall report on transfer of securities to the board of directors in each meeting.

The auditor should ascertain from the minutes book of the Board meetings whether the listed entity has delegated the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The auditor should also verify from the records maintained to ascertain whether the delegated authority has attended to share transfer formalities at least once in a fortnight. The auditor may verify whether any transfer request are pending for more than a fortnight and are not attended to in terms of this Regulation.

9.19 Compliance Certificate [Part B of Schedule II]

The Chief Executive Officer and the Chief Financial Officer shall certify to the Board that:

- (a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:
 - (i) These statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;*
 - (ii) These statements together present a true and fair view of the listed entity's affairs and are in compliance with existing accounting standards, applicable laws and regulations.**
- (b) There are, to the best of their knowledge and belief, no transactions entered into by the listed entity during the year which are fraudulent, illegal or violative of the listed entity's code of conduct.*
- (c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of the internal control systems of the listed entity pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or*

operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

- (d) They have indicated to the auditors and the Audit committee:**
- (i) Significant changes in internal control over financial reporting during the year;**
 - (ii) Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and**
 - (iii) Instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the listed entity's internal control system over financial reporting."**

Part B of Schedule II clearly brings out that -

The responsibility entrusted to the CEO and CFO is in relation to establishing and maintaining internal controls over financial reporting.

The Compliance Certificate has to assert that they have evaluated the effectiveness of internal control systems of the listed entity pertaining to financial reporting.

The Compliance Certificate will further state the manner in which deficiencies (if any) in the design or operation of such internal controls has been disclosed to the auditors and the Audit Committee.

The Compliance Certificate will also state the steps they have taken or propose to take to rectify these deficiencies in the design or operation of such internal controls pertaining to financial reporting.

In the context of internal controls, the auditor should ensure that -

The management has instituted an internal control framework with respect to financial reporting controls. The framework should be examined in the context of the documentation created for each significant process in terms of the related risk and mitigating control;

He has further examined whether the assessment process followed for evaluation of controls is reasonable and there is a process by which significant deficiencies as well as steps taken to correct them is communicated to the Audit Committee and to the auditors; and

He should also examine whether a process exists in the listed entity whereby all significant changes in the accounting policies and in the system of internal controls are communicated to the Audit Committee and the auditors.

The auditor should examine the adequacy of the process followed for issuing the Compliance Certificate and should review the same in regard to matters stated above and the consideration of the same by the Audit Committee. For this purpose he should refer to the minutes of the Audit Committee meetings.

In situations where negative or adverse comments or exclusions/disclaimers are contained in the Compliance Certificate, the auditor should take cognizance of the same in the Audit Report and/or the certificate of compliance of conditions of corporate governance.

9.20 Disclosures

The LODR Regulations on Corporate Governance requires disclosure of certain transactions which are discussed below.

9.20.1 Disclosure and Transparency [Regulation 4]



The listed entity shall ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the Listed entity, in the following manner:

- (a) *Information shall be prepared and disclosed in accordance with the prescribed standards of accounting, financial and non-financial disclosure.*
- (b) *Channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by users.*
- (c) *Minutes of the meeting shall be maintained explicitly recording dissenting opinions, if any.*

9.20.2 Related Party Disclosure [Regulations 27, 46 and Schedule V]

The listed entity shall submit a quarterly compliance report on corporate governance in the format as specified by the Board from time to time to the recognised stock exchange(s) within fifteen days from close of the quarter.

Details of all material transactions with related parties shall be disclosed therein. The report shall be signed either by the compliance officer or the chief executive officer of the listed entity.

The company shall disclose the policy on dealing with related party transactions on its website and a web link thereto shall be provided in the Annual Report.

9.20.3 Disclosure of Accounting Treatment [Schedule V]

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction.

In this regard, the auditor should refer to Sections 133, 134 and 143 of the Companies Act, 2013. Also, the auditor should refer to the Compliance Certificate issued in accordance with Regulation 17.

9.21 Risk Management Committee [Regulation 21]

- (a) *The Board of Directors shall constitute a Risk Management Committee.*

- (b) *The majority of members of Risk Management Committee shall consist of members of the Board of Directors.*
- (c) *The Chairperson of the Risk Management Committee shall be a member of the Board of Directors and senior executives of the listed entity may be members of the committee.*
- (d) *The Board of Directors shall define the role and responsibility of the Risk Management Committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit.*
- (e) *The provisions of this regulation shall be applicable to top 100 listed entities, determined on the basis of market capitalisation, as at the end of the immediate previous financial year.*

These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. A majority of this Committee will be the members of the Board of Directors. Senior executives of the company may be also be members of the Committee, but the Chairperson of the Committee shall be a member of the Board of Directors.

9.22 Nomination and Remuneration Committee [Regulation 19 and Part D of Schedule II]

- A. *The Board of Directors shall constitute the Nomination and Remuneration Committee which shall comprise at least three directors, all of whom shall be non-executive directors and at least half shall be independent. Chairperson of the committee shall be an independent director.*

Provided that the Chairperson of the listed entity (whether executive or nonexecutive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such committee.

- B. *The role of such committee shall, inter-alia, include the following:*
 - (i) *Formulation of the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board of Directors a policy, relating to the remuneration of the directors, key managerial personnel and other employees;*
 - (ii) *Formulation of criteria for evaluation of independent directors and the Board of Directors;*
 - (iii) *Devising a policy on Board diversity;*
 - (iv) *Identifying persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, and recommend to the Board their appointment and removal.*

- (v) *whether to extend or continue the term of appointment of the independent director, on the basis of the report of performance evaluation of independent directors.*
- C. *The Chairperson of the Nomination and Remuneration Committee may be present at the Annual General Meeting, to answer the shareholders' queries. However, it would be up to the Chairperson to decide who shall answer the queries.*

9.23 Report on Corporate Governance [Regulation 27 and Schedule II]

The listed entity shall submit a quarterly compliance report on corporate governance in the format as specified by the Board from time to time to the recognised stock exchange(s) within 15 days from the close of quarter. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the listed entity.

The auditor should ascertain whether the Board of Directors have included in the Annual Report of the listed entity, a separate section on corporate governance with a detailed compliance report on corporate governance.

Any data in the report on corporate governance should not be inconsistent with that contained in the financial statements. (For detailed contents of Report on Corporate Governance, students are advised to refer Appendix given at the end of this Chapter)

9.24 Auditors' Certificate

As per Schedule V, a listed entity shall obtain a compliance certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance and shall annex it to the Directors' Report.

9.24.1 Adverse or Qualified Statement

Depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of corporate governance for e.g.,

Examples of such circumstances:

- (a) *The number of non-executive directors is less than 50% of the strength of Board of directors.*
- (b) *A qualified and independent audit committee is not set up.*
- (c) *The Chairman of the audit committee is not an independent director.*
- (d) *The Audit Committee does not meet four times a year.*
- (e) *The necessary powers in terms of Part C of Schedule II have not been vested by the Board in the Audit Committee.*

- (f) The time gap between two Board meetings is more than one hundred and twenty days.*
- (g) A director is a member of more than ten committees or acts as Chairman of more than five committees across all companies in which he is a director.*
- (h) The information of quarterly results is neither put on the listed entity's website nor sent in a form so as to enable the stock exchange on which the entity's securities are listed to enable such stock exchange to put it on its own website.*
- (i) The power of share transfer is not delegated to an officer or a committee or to the registrar and share transfer agents.*

Case Studies –

Statements appearing in the Auditors' certificate on compliance of conditions of corporate governance:

- 1. ABC Oil & Natural Gas Commission - Non-compliance with (a) appointment of minimum number of independent directors (b) filling up the vacancies caused due to the resignation or retirement of independent directors within the specified time period and (c) appointment of woman director to the Board during certain specified periods.**
- 2. XYZ Bank - Non-compliance with appointment of woman director to the Board for the F.Y.2015-16.**
- 3. PQR Electrification Corporation Limited - Non-compliance with appointment of woman director to the Board**
- 4. RST Oil Corporation Limited - Non-compliance with (a) minimum number of independent directors in the composition of Board of Directors (b) appointment of woman director from 29.10.2015 (c) filling up the vacancies caused due to the retirement of independent directors for part of the year.**
- 5. RKP National Fertilizers Limited - Non-compliance with (a) minimum number of independent directors in the composition of Board of Directors (b) appointment of woman director (c) performance evaluation of independent directors by the entire Board of Directors and (d) performance evaluation by the independent directors of the non-independent directors, that of the board of directors as a whole and that of the Chairperson of the company.**

A performa of the certificate to be issued by the auditors regarding compliance of conditions of corporate governance is shown below:

CERTIFICATE

To,

The Members of.....

(Name of the entity)

We have examined the compliance of conditions of corporate governance by (name of the entity) for the year ended on as stipulated in Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (hereinafter called as "SEBI (LODR) Regulations, 2015").

The compliance of conditions of corporate governance is the responsibility of the management. Our examination was limited to procedures and implementation thereof, adopted by the company for ensuring the compliance of the conditions of the corporate governance. It is neither an audit nor an expression of opinion on the financial statements of the company.

In our opinion and to the best of our information and according to the explanations given to us, we certify that the company has complied with the conditions of corporate governance as stipulated in the above mentioned Regulations.

OR (as applicable)

In our opinion, and to the best of our information and according to the explanations given to us, subject to the following:

1)

2)

We certify that the company has complied with the conditions of corporate governance as stipulated in the above mentioned Regulations.

We state that such compliance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

For & on behalf of

XYZ & Co.

Chartered Accountants

(Partner / Proprietor)

Membership No.

Place.....

Date.....

APPENDIX

SCHEDULE II: CORPORATE GOVERNANCE

PART A: MINIMUM INFORMATION TO BE PLACED BEFORE BOARD OF DIRECTORS

[See Regulation 17(7)]

- A. Annual operating plans and budgets and any updates.**
- B. Capital budgets and any updates.**
- C. Quarterly results for the listed entity and its operating divisions or business segments.**
- D. Minutes of meetings of audit committee and other committees of the board of directors.**
- E. The information on recruitment and remuneration of senior officers just below the level of board of directors, including appointment or removal of Chief Financial Officer and the Company Secretary.**
- F. Show cause, demand, prosecution notices and penalty notices, which are materially important.**
- G. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.**
- H. Any material default in financial obligations to and by the listed entity, or substantial non-payment for goods sold by the listed entity.**
- I. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the listed entity or taken an adverse view regarding another enterprise that may have negative implications on the listed entity.**
- J. Details of any joint venture or collaboration agreement.**
- K. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.**
- L. Significant labour problems and their proposed solutions. Any significant development in Human Resources/ Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.**
- M. Sale of investments, subsidiaries, assets which are material in nature and not in normal course of business.**
- N. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.**
- O. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.**

10

Audit of Consolidated Financial Statements

10.1 Introduction



Fig.: Consolidation*

Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, consolidated cash flow statement, a consolidated statement of change in equity (if applicable) and any explanatory notes annexed to, or forming part thereof. Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements. The formats for preparation of balance sheet, statement of profit and loss and a statement of change in equity (if applicable) are prescribed under the Schedule III of the Companies Act, 2013.

An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or suo motu, might be required to or otherwise engage the auditor for conducting the audit of consolidated financial statements. However, a law

* Source : Business line

or regulation governing the entity may require the consolidated financial statements to be audited by the statutory auditor of the entity. The Guidance Note on Audit of Consolidated Financial Statements provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements. This Guidance Note can also be used while auditing consolidated financial statements prepared for special purpose, to the extent applicable but it does not deal with accounting matters arising on consolidation of financial statements.

10.1.1 Consolidation of Financial Statements - Now Mandatory under Companies Act, 2013

According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. Further, section 129(4) of the said Act, provides that the provisions applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, also apply to the consolidated financial statements.

The Consolidated financial statements shall also be approved by the board of directors before they are signed on behalf of the board, along with its own financial statements and shall also be laid before the annual general meeting of the company along with the laying of its own financial statement.

The company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in Form AOC-1.

According to Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act [refer Appendix given at the end of Chapter 6].

However, the requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:

(i) it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;

(ii) it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and

(iii) its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

10.3 Advanced Auditing and Professional Ethics

As per sub-section 6 of the section 129 of the Companies Act, 2013, the Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of section 129 or the rules made thereunder, if it is considered necessary to grant such exemption in the public interest and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

Thus, the companies having subsidiaries, which have previously never prepared the consolidated financial statements, must prepare their consolidated financial statements in adherence with this mandatory requirement. This will provide the holding companies' stakeholders more transparency about the companies' businesses.

10.2 Definitions

Various terms used in this Guidance Note, have the same meaning as defined in applicable accounting standards. Important terms definition are given below:

Terms defined under Accounting Standards

1. **Associate:** *An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.*
2. **Consolidated financial statements:** *Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.*
3. **Control:**
 - a. *The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or*
 - b. *control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.*
4. **Group:** *A group comprises a parent and its subsidiaries.*
5. **Joint control:** *Joint control is the contractually agreed sharing of control over an economic activity.*
6. **Joint venture:** *A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.*
7. **Minority interest:** *Minority interest is that part of the net results of operations and of net assets of a subsidiary attributable to interests which are not owned, directly or indirectly, through subsidiary(ies), by the parent.*
8. **Parent:** *A parent is an enterprise that has one or more subsidiaries.*
9. **Significant influence:** *Significant influence is the power to participate in the financial and/ or operating policy decisions of the investee but not control over those policies.*
10. **Subsidiary:** *A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).*

Terms defined under Ind AS

1. **Associate:** *An associate is an entity over which the investor has significant influence.*
2. **Control of an investee:** *An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.*
3. **Consolidated financial statements:** *The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.*
4. **Group:** *A parent and its subsidiaries.*
5. **Joint Control:** *Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.*
6. **Joint Venture:** *A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.*
7. **Non-controlling Interest:** *Equity in a subsidiary not attributable, directly or indirectly, to a parent.*
8. **Parent:** *An entity that controls one or more entities.*
9. **Power:** *Existing rights that give the current ability to direct the relevant activities.*
10. **Relevant Activities:** *Relevant activities are activities of the investee that significantly affect the investee's returns.*
11. **Significant influence:** *Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.*
12. **Subsidiary:** *An entity that is controlled by another entity.*
13. **Separate Financial Statements:** *separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109, 'Financial Instruments'.*

Terms defined under SA 600, "Using the Work of Another Auditor"

1. **Component:** *It is a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by principal auditor.*

10.3 Responsibility of Parent

The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:

- (a) identifying components, and including the financial information of the components to be included in the consolidated financial statements;
- (b) where appropriate, identifying reportable segments for segmental reporting;
- (c) identifying related parties and related party transactions for reporting;

- (d) obtaining accurate and complete financial information from components; and
- (e) making appropriate consolidation adjustments.
- (f) harmonization of accounting policies and accounting framework; and.**
- (g) GAAP conversion, where applicable.**

Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

10.4 Responsibility of the Auditor of the Consolidated Financial Statements

Section 129(4) of the Companies Act, 2013 requires that the provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements. Besides other matters, the principal auditor of the consolidated financial statements is



responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects, in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements in addition to reporting on the additional matters as required under the Companies Act, 2013 and any other statute to the extent applicable.

Fig.: Responsibility of Auditors*

Therefore, the auditor's objectives in an audit of consolidated financial statements are:

- (a) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of applicable financial reporting framework;**
- (b) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements.**
- (c) to enquire into the matters as specified in section 143(1) of the Companies Act, 2013; and.**
- (d) to report on the matters given in the clauses (a) to (i) of section 143(3) of the Companies Act, 2013; for other matters under section 143(3)(j) read with rule 11 of**

* Source : Business Insurance

the Companies (Audit and Auditors) Rules, 2014, to comment on the matters specified in sub-rule (a),(b) and (c)² to the extent applicable.

Standards on Auditing, Statements and Guidance Notes on auditing matters issued by the Institute of Chartered Accountants of India apply in the same manner to audit of consolidated financial statements as they apply to audit of separate financial statements. It means that the auditors, while conducting the audit of consolidated financial statements are, *inter alia*, expected to:

- (a) plan their work to enable them to conduct an effective audit in an efficient and timely manner;
- (b) ***obtain an understanding of the accounting and internal control systems including IT system like consolidation tool, sufficient to plan the audit and determine the nature, timing and extent of his audit procedures. Such an understanding would help the auditors to develop an effective audit approach;***
- (c) use professional judgement to assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptable level; etc.

10.5 Audit Considerations

The following features of consolidated financial statements have an impact on the related audit procedures:

- (a) ***The consolidated financial statements are prepared on the basis of separate financial statements of the parent and its components, using the consolidation procedures prescribed by Accounting Standards³ under applicable financial reporting framework; and***
- (b) ***The auditor of the consolidated financial statements may use the work of other auditors as per requirement of Standards on Auditing unless the auditor of consolidated financial statements is also the auditor of the other components of the group.***

The consolidated financial statements (including the intermediate consolidated financial statements prepared internally)⁴ are prepared using the separate financial statements of the parent and its components and also other financial information, which might not be covered by the separate financial statements of these entities. The 'other financial

² The auditor of the consolidated financial statements generally report on the matters pertaining to the component, on the basis of auditors' report of the respective component.

³ Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS 23)- Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) - 27, Financial Reporting of Interests in Joint Ventures OR Indian Accounting Standard (Ind AS) 110 – Consolidated Financial Statements, Indian Accounting Standard (Ind AS) 111- Joint Arrangements, Indian Accounting Standard (Ind AS) 112 –Disclosure of Interests in Other Entities and Indian Accounting Standard (Ind AS) 28 – Investments in Associates and Joint Ventures.

⁴ Intermediate consolidated financial statements are the consolidated financial statements of an intermediate parent, e.g., Company A has one subsidiary Company B. Company B has a subsidiary Company C. In this case, Company B is the intermediate parent and the consolidated financial statements prepared by Company B will be intermediate consolidated financial statements.

information' would include disclosures to be made in the consolidated financial statements about the components, proportion of items included in the consolidated financial statements to which different accounting policies have been applied where permitted, adjustments made for the effects of significant transactions or other events that occur between the financial statements of parent and its components, as the case may be, etc. Thus, this 'other financial information' would be required to be additionally disclosed.

When an auditor accepts the audit of consolidated financial statements, the auditor should assess whether based on his work alone he would be able to express an opinion on the true and fair view presented by the consolidated financial statements. If the auditor is of the view that his own participation may not be enough or sufficient, he should consider using the work of 'other auditors'.

Such 'other auditors' might be the statutory auditors of the separate financial statements of one or more of the components or the auditors appointed specifically for assisting the auditor of the consolidated financial statements (the principal auditor).

Where the statutory auditors of one or more of the components of the parent are also requested to assist the principal auditor, the work to be performed by such statutory auditors for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory audit of the respective component.

Standard on Auditing (SA) 600, 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity (Paragraph 2 of SA 600). The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, should comply with the requirements of SA 600.

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

- *The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.*
- *The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider*

using the work of other auditors as applicable⁵.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the concept of materiality would not be considered. Thus, the component auditor's observations, if any, on the component's financial statements, irrespective of whether the auditors of the component are also the auditors of the CFS or not, are required to be included in the parent auditor's report on the CFS, regardless of materiality.

10.6 Auditing the Consolidation

Before commencing an audit of consolidated financial statements, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. The auditor should make plans, among other things, for the following:

- (a) Understanding of the group structure and group-wide controls including assessment of Information Technology (IT) system and related general and applications IT related controls (manual and automated) for consolidation process;*
- (b) understanding of accounting policies of the parent and its components as well as of the consolidation process including the process of translation of financial statements of foreign components;*
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed based on the assessment of the risk of material misstatement in the consolidation process;*
- (d) determining the extent of use of other auditor's work in the audit; and*
- (e) coordinating the work to be performed.*

A parent which presents consolidated financial statements is required to consolidate all its components in the consolidated financial statements other than those for which exceptions have been provided in the relevant accounting standards under the applicable financial reporting framework.

The auditor should obtain a listing of all the components included in the consolidated financial statements and review the information provided by the management of the parent identifying the components. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion as referred to in paragraph 19 above. In respect of completeness of this information, the auditor should perform the following procedures:

- (a) review his working papers for the prior years for the known components;*
- (b) review the parent's procedures for identification of various components;*

⁵ Refer ICAI's Announcement on the Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s) issued in February 2014.

- (c) *make inquiries of management to identify any new components or any component which goes out of consolidated financial statements.*
- (d) *review the investments of parent as well as its components to determine the shareholding in other entities;*
- (e) *review the joint ventures and joint arrangements as applicable;*
- (f) *review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group.*
- (g) *review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013.*
- (h) *also identify the changes in the shareholding that might have taken place during the reporting period.*

The auditor should document procedures performed for assessing completeness of the components to be consolidated.

There would be various means by which control, joint control or significant influence can be obtained. In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know how, enforcement of statute, as the case may be, etc. The auditor may also review the minutes of the meetings of the Board of Directors subsequent to the year-end to understand if there has been any liquidation of investments or any further investments have been made as these may provide further evidence to understand if the control was meant to be temporary in nature or otherwise.

Where a component is excluded from the consolidated financial statements, the auditor should examine the reasons for exclusion and whether such exclusion is in conformity with the applicable financial reporting framework, for example, under the Companies (Accounting Standards) Rules, 2006, there could be two reasons for exclusion of a subsidiary, associate or jointly controlled entity – one, that the relationship of parent with the subsidiary, associate or jointly controlled entity is intended to be temporary or the subsidiary, associate or joint venture operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent. Similarly, under the Companies Act, 2013, intermediate subsidiary in India is not required to present consolidated financial statements. Ind AS 110 also prescribes certain criteria where consolidated financial statements are not required. In such cases, the auditor should satisfy himself that the exclusion made by the management falls within these categories, e.g. in the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary, associate or joint venture is temporary, the auditor should verify that the intention of the parent, to dispose off the subsidiary, investment in associate or interest in jointly controlled entity, in the near future, existed at the time of acquisition of the subsidiary, making investment in associate or jointly controlled entity. The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements. If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the applicable

financial reporting framework, the auditor should consider its effect on the auditor's report to be issued.

The auditor should also examine whether there is any change in the status of a component (e.g., subsidiary to associate, JV to associates or vice – versa). The auditor, in such cases, should examine whether these changes have been appropriately accounted for in the consolidated financial statements as required by the relevant accounting standards under the applicable financial reporting framework.

(a) In preparing consolidated financial statements in accordance with the Companies (Accounting Standards) Rules, 2006, the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, income, expenses and cash flows and then certain calculations like determination of goodwill or capital reserve, minorities interest and adjustments like elimination of intra group transactions, balances and unrealised profits etc. are made in accordance with the requirements of Accounting Standard (AS) 21, "Consolidated Financial Statements". Investments in associates are accounted for using the Equity Method as prescribed in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements". A parent that has an interest in a jointly controlled entity, reports its interest in the consolidated financial statements using proportionate consolidation method in accordance with Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures". Many of the procedures appropriate for the application of equity method and the proportionate consolidation method are similar to the consolidation procedures set out in Accounting Standard (AS) 21, "Consolidated Financial Statements".

(b) For consolidation of subsidiaries in accordance with the Companies (Indian Accounting Standards) Rules, 2015:

- the financial statements of the parent and its subsidiaries are combined as per Ind AS 110, "Consolidated Financial Statements" on a line by line basis by adding together like items of assets, liabilities, income, expenses and cash flows;*
- related goodwill/ capital reserve and non-controlling interest is determined as per Ind As 103;*
- adjustments like elimination of intra group transactions, balances, unrealised profits and deferred tax etc. are made in accordance with the requirements of Ind AS 110.*
- Investments in associates and joint ventures are accounted for using the Equity Method as prescribed in Indian Accounting Standard (Ind AS) 28, "Investments in Associates and Joint Ventures". Interests in assets, liabilities, revenues and expenses in a joint operation are accounted for as part of separate financial statements of the entity in accordance with Indian Accounting Standard (Ind AS) 111, "Joint Arrangements".*

The auditor should verify that the adjustments warranted by the relevant accounting standards under the applicable financial reporting framework have been made wherever required and have been properly approved by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. No adjustments, other than

those envisaged in this Guidance Note, can be carried out in the preparation of CFS at the group level.

10.7 Special Considerations

10.7.1 Permanent Consolidation Adjustments

Permanent consolidation adjustments are those adjustments that are made only on the first occasion or subsequent occasions in which there is a change in the shareholding of a particular entity which is consolidated. Permanent consolidation adjustments are:

(a) Determination of goodwill or capital reserve as per applicable accounting standards.

(b) Determination of amount of equity attributable to minority/ non-controlling interests.

The auditor should verify that the above calculations have been made appropriately. The auditor should pay particular attention to the determination of pre-acquisition reserves of the components. Date(s) of investment in components assumes importance in this regard. The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minority interests/ non-controlling interests of the subsidiary. The auditor should also verify the changes that might have taken place in these permanent consolidation adjustments on account of subsequent acquisition of shares in the components, disposal of the components in the subsequent years.

It may happen that while working out the permanent consolidation adjustments, in the case of one subsidiary, goodwill arises and in the case of another subsidiary a capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet where permitted by the applicable financial reporting framework. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

10.7.2 Current Period Consolidation Adjustments

Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including:

- (a) intra-group interest paid and received, or management fees, etc.;

- (b) *unrealised intra-group profits on assets acquired/ transferred from/ to other subsidiaries;*
- (c) *intra-group indebtedness;*
- (d) *adjustments related to harmonising the different accounting policies being followed by the parent and its components;*
- (e) *adjustments to the financial statements (of the parent and the components being consolidated) for recognized subsequent events or transactions that occur between the balance sheet date and the date of the auditor's report on the consolidated financial statements of the group.*

There are two types of subsequent events:

- a. *The first type of subsequent events consists of events or transactions that provide additional evidence about conditions that existed at the date of the financial statements, including the estimates inherent in the process of preparing financial statements (i.e. adjusting events).*
- b. *The second type of subsequent events consists of events that provide evidence about conditions that did not exist at the date of the financial statements but arose subsequent to that date (i.e. non-adjusting events).*

Events occurring after balance sheet date which do not require adjustments would not normally require disclosure, although they may be of such significance that they may require a disclosure in the report of approving authority in the case of accounting standards and in the financial statements in case of Ind AS. For such events, the following shall be disclosed:

- a. *The nature of the event; and*
 - b. *An estimate of its financial effect or a statement that such an estimate cannot be made.*
- (f) *adjustments for the effects of significant transactions or other events that occur between the date of the components balance sheet and not already recognised in its financial statements and the date of the auditor's report on the group's consolidated financial statements when the financial statements of the component to be used for consolidation are not drawn upto the same balance sheet date as that of the parent;*
 - (g) *In case of a foreign component, adjustments to convert a component's audited financial statements prepared under the component's local GAAP to the GAAP under which the consolidated financial statements are prepared.*
 - (h) *determination of movement in equity attributable to the minorities interest/non-controlling interest since the date of acquisition of the subsidiary.*
 - (i) *adjustments of deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from intragroup transactions and undistributed profits of the component in case of consolidated financial statements prepared under Ind AS.*

The adjustments required for preparation of consolidated financial statements are made in memorandum records kept for the purpose by the parent. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. Apart from reviewing the memorandum records, the auditor should inter alia:

- (a) verify that the intra group transactions and account balances have been eliminated;*
- (b) verify that the consolidated financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances;*
- (c) verify that adequate disclosures have been made in the consolidated financial statements of application of different accounting policies in case, it was impracticable to harmonize them. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so⁶.*
- (d) verify the adjustments made to harmonise the different accounting policies including adjustments made by management to convert a component's financial statements prepared under the component's GAAP to the GAAP under which the consolidated financial statements are prepared;*
- (e) verify the calculation of minorities/non-controlling interest;*
- (f) verify adjustments relating to deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from Intergroup transactions (where the parent's accounts are maintained in Ind AS);*
- (g) verify that income and expenses of the subsidiary are included in consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognised in consolidated financial statements at the acquisition date⁷.*

The auditor should gain an understanding of the procedures adopted by the management of the enterprise to make the above mentioned adjustments. This helps the auditor in reducing the audit risk to an acceptably low level.

One of the important adjustment that may be required in the current period is determination of impairment loss that might exist for goodwill arising on consolidation. Goodwill arising on consolidation is carried at the value determined at the date of

⁶ AS 21/ AS 23/ AS 27 permit application of different accounting policies, if it is impractical to use uniform accounting policies, that fact should be disclosed together with the proportion of the items in the consolidated financial statements to which the different accounting policies have been applied. Ind AS 28 permits that financial statement of an associate can be prepared using different accounting policies if it is impractical to do so however adjustment shall be made to make the accounting policies conform to those of parent when the financial statements are used by parent in applying the equity method.

⁷ Where the consolidated financial statements are prepared under Indian Accounting Standards.

acquisition of the component, and the same is to be tested for impairment loss at every balance sheet date.

The auditor should examine whether any impairment loss has been determined by the parent. If yes, the auditor should examine the procedure followed for determination of impairment loss. The auditor should satisfy himself that the amount of impairment loss determined is fair. In case the impairment loss in goodwill of a component has been determined in foreign currency, the auditor should verify if any amount of loss in local currency need to be adjusted from currency translation reserve on account of movement in the exchange rate from the date when the goodwill was first accounted for in the consolidated financial statement of parent, to the date of determination of impairment loss.

The auditor should also perform audit procedures to understand and verify whether Intragroup losses are indicating an impairment loss that requires recognition in the consolidated financial statements.

Apart from verifying that the calculation and disclosures regarding minorities/non-controlling interest have been made appropriately, the auditor also determines, in cases where the minority interests' share of the losses exceed the minority /non-controlling interests' share of the equity, the excess, and any further losses applicable to the minority interest, have been accounted for in accordance with the relevant accounting standards.

The financial statements of the components used in the consolidation should be drawn up to the same reporting date as that of the parent. If it is not practicable to draw up the financial statements of one or more components to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months in case of financial statements under AS and three months in case of financial statements under Ind AS. The auditor of the consolidated financial statements should review other components' results between its financial reporting date and that of the parent for significant transactions or other events that have taken place during the period and, therefore, need to be reflected in the consolidated financial statements. Recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position, results of operations or cash flows.

The fundamental accounting assumption of "consistency" requires the auditor of the consolidated financial statements to consider whether the length of the reporting periods and any difference in financial year-ends are the same from period to period. If there have been any changes in the respective reporting periods of the components included in the consolidated financial statements that have a material effect on the financial statements, the auditor should ensure that the entity discloses such changes and the manner of treatment in the financial statements.

The Ministry of Corporate Affairs has issued a Circular number 39/2014 dated October 14, 2014 stating that Schedule III to the Act read with the applicable Accounting Standards does not envisage that a company while preparing its consolidated financial statements merely repeats the disclosures made by it under separate financial statements being consolidated. In the consolidated financial statements, the company would need to give all disclosures relevant to consolidated financial statements only.

Further, Accounting Standard (AS) 21 also lays down certain principles that should be observed while giving the information which is part of the separate financial statements of the Components but that need not be reported in the notes and other explanatory material of the consolidated financial statements. The auditor should:

- (a) examine that the notes required by the applicable standards which are necessary for presenting a true and fair view of the consolidated financial statements have been included in the consolidated financial statements as an integral part thereof; and*
- (b) examine that additional statutory information disclosed in the separate financial statements of the subsidiary and/or a parent having bearing on the true and fair view of the consolidated financial statements have been disclosed in the consolidated financial statements.*

In addition, the information required pursuant to Schedule III to the Companies Act, 2013 ('general instructions for the preparation of consolidated financial statements') should be disclosed. For example, following information is also required to be disclosed in the consolidated financial statements separately for the parent and each of its components (including foreign component) which has been consolidated:

- (i) amount of net assets and net assets as a percentage of consolidated net assets;*
- (ii) amount of share in profit or loss and the percentage share in profit or loss as a percentage of consolidated profit or loss;*
- (iii) amount in other comprehensive income (OCI) and the percentage of OCI as a percentage of Consolidated OCI.⁸*

As regards consolidation adjustments (including elimination of intra group transactions), it should be ensured that these are either disclosed as a single line item separately or adjusted in the information (e.g. net assets) disclosed for the parent and its each component.

The Ind AS 110 does not give a list of information which is part of the separate financial statement of the components but that need not be reported in the notes and other explanatory material of the consolidated financial statements, however, based on section 129(4) and MCA circular 39/2014 as referred above, it can be construed that, even in consolidated financial statements under Ind AS, only those disclosures should be given which are relevant to consolidated financial statements.

⁸ For companies which are covered by Ind AS.

Based on the above discussion, in case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary, need not be included in the consolidated financial statements.

- (i) Source from which bonus shares are issued, e.g., capitalisation of profits or Reserves or from Securities Premium Account.*
- (ii) Disclosure of all unutilised monies out of the issue indicating the form in which such unutilised funds have been invested.*
- (iii) Disclosure required under Micro, Small and Medium Enterprises Development Act, 2006.*
- (iv) A statement of investments (whether shown under “financial assets or non-financial assets as stock-in-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.*
- (v) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of:*
 - (a) raw materials;*
 - (b) components and spare parts;*
 - (c) capital goods.*
- (vi) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters.*
- (vii) Value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.*
- (viii) The amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related.*
- (ix) Earnings in foreign exchange classified under the following heads, namely:-*
 - (a) export of goods calculated on F.O.B. basis;*
 - (b) royalty, know-how, professional and consultation fees;*
 - (c) interest and dividend;*
 - (d) other income, indicating the nature thereof.*

However, notwithstanding the above, the auditor needs to ensure compliance with disclosure requirements of applicable accounting standards and other applicable laws for consolidated financial statements.

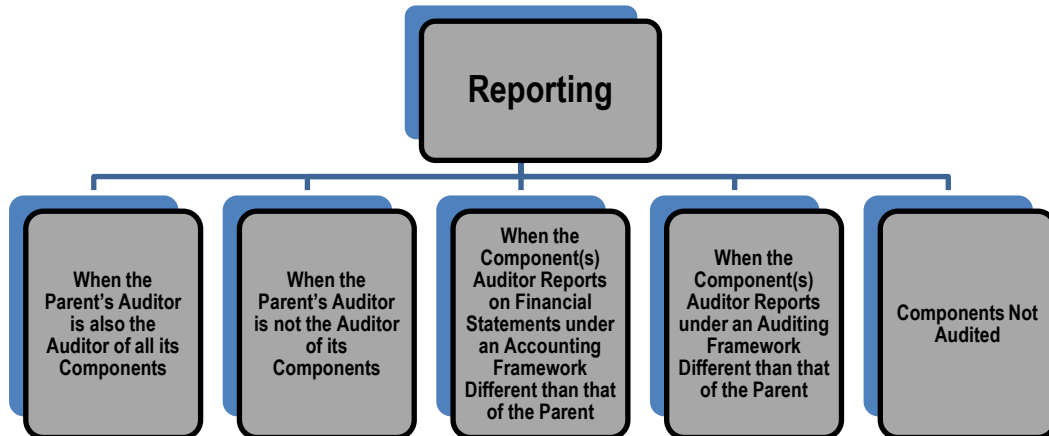
10.8 Management Representations

SA 580, "Written Representations" requires the auditor to obtain written representations from management and, where appropriate, those charged with governance. The auditor of the consolidated financial statements should obtain evidence that the management of the parent acknowledges its responsibility for a true and fair presentation of the consolidated financial statements in accordance with the financial reporting framework applicable to the parent and that parent management has approved the consolidated financial statements. In addition, the auditor of the consolidated financial statements obtains written representations from parent management on matters material to the consolidated financial statements. Examples of such representations include:

- (a) Completeness of components included in the consolidated financial statements;
- (b) Identification of reportable segments for segmental reporting;
- (c) Identification of related parties and related party transactions for reporting;
- (d) ***Appropriateness and completeness of permanent and current period consolidation adjustments, including the elimination of intra-group transactions.***

10.9 Reporting

There could be two situations in an audit of consolidated financial statements—when the parent's auditor is also the auditor of all the components to be included in the consolidated financial statements and when the parent's auditor is not the auditor of one or more components and therefore, uses the work of other auditors in the audit. ***The auditor should, while preparing the report, consider the requirements of Standard on Auditing (SA) 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.*** Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of SA 600, "Using the Work of Another Auditor" should also be considered.



10.9.1 When the Parent’s Auditor is also the Auditor of all its Components

While drafting the audit report, the auditor should report whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed. In case of any departure or deviation, the auditor should make adequate disclosure in the audit report so that users of the consolidated financial statements are aware of such deviation. Auditor should issue an audit report expressing opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit. Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statements.

10.9.2 When the Parent’s Auditor is not the Auditor of all its Components

In a case where the parent’s auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of SA 600.

As prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor’s report on the consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent’s auditor. Total assets, revenues and cash flows not audited by the parent’s auditor should be presented before giving effect to permanent and current period consolidation adjustments. Reference in the report of the auditor on the consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries.

10.9.3 When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent

The parent may have components located in multiple geographies outside India applying an accounting framework (GAAP) that is different than that of the parent in preparing its financial statements. Foreign components prepare financial statements under different financial reporting frameworks, which may be a well-known framework (such as US GAAP or IFRS) or the local GAAP of the jurisdiction of the component. Local component auditors may be unable to report on financial statements prepared using the parent's GAAP because of their unfamiliarity with such GAAP.

When a component's financial statements are prepared under an accounting framework that is different than that of the framework used by the parent in preparing group's consolidated financial statements, the parent's management perform a conversion of the components' audited financial statements from the framework used by the component to the framework under which the consolidated financial statements are prepared. The conversion adjustments are audited by the principal auditor to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation. Suggested format of the audit report to be issued by the auditor of the consolidated financial statements in this circumstance is given in Appendix I to this Guidance Note.

A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared. The local component auditor can then audit and issue an audit report on the components financial statements prepared in accordance with "group accounting policies".

When applying the approach in paragraph 53 above of using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent's financial statements. This ensures that the information prepared under the requirements of the group accounting policies will be directly usable and relevant for the preparation of consolidated financial statements by the parent entity, eliminating the need for auditing by the auditor, the differences between the basis used for the component's financial statements and that of the consolidated financial statements. The Principal auditor can then decide whether or not to rely on the components' audit report and make reference to it in the auditor's report on the consolidated financial statements. See paragraph 50 for additional guidance.

10.9.4 When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent

Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("Indian GAAS"). In order to maintain consistency of the auditing framework and to enable the parent auditor to rely and refer to the other auditor's audit report in their audit report on the consolidated financial statements, the components' financial statements should also be audited under a framework that corresponds to Indian GAAS.

10.9.5 Components Not Audited

Generally, the financial statements of all components included in consolidated financial statements should be audited or subjected to audit procedures in the context of a multi-location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both qualitative and quantitative factors on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Note: Students may refer Appendix 1 of Guidance Note on Consolidated Financial Statements for illustrative format of independent auditor's report on the consolidated financial statements of a group under the Companies Act, 2013 and the rules thereunder.

FINAL COURSE STUDY MATERIAL

PAPER 3

**Advanced Auditing and
Professional Ethics**

MODULE – 2



**BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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CONTENTS

MODULE – 1

- Chapter 1 – Auditing Standards, Statements and Guidance Notes – An Overview
- Chapter 2 – Audit Strategy, Planning and Programming
- Chapter 3 – Risk Assessment and Internal Control
- Chapter 4 – Audit under Computerised Information System (CIS) Environment
- Chapter 5 – Special Audit Techniques
- Chapter 6 – The Company Audit
- Chapter 7 – Liabilities of Auditors
- Chapter 8 – Audit Report
- Chapter 9 – Audit Committee and Corporate Governance
- Chapter 10 – Audit of Consolidated Financial Statements

MODULE – 2

- Chapter 11 – Audit of Banks
- Chapter 12 – Audit of General Insurance Companies
- Chapter 13 – Audit of Co-Operative Societies
- Chapter 14 – Audit of Non Banking Financial Companies
- Chapter 15 – Audit under Fiscal Laws
- Chapter 16 – Cost Audit

MODULE – 3

- Chapter 17 – Special Audit Assignments
- Chapter 18 – Audit of Public Sector Undertakings
- Chapter 19 – Internal Audit, Management and Operational Audit
- Chapter 20 – Investigation and Due Diligence
- Chapter 21 – Peer Review
- Chapter 22 – Professional Ethics

DETAILED CONTENTS: MODULE – 2

CHAPTER 11: AUDIT OF BANKS

11.1	Introduction	11.1
11.2	Legal Framework	11.1
11.3	Form and Content of Financial Statements	11.2
11.4	Audit of Accounts	11.2
11.5	Internal Control in Certain Selected Areas	11.10
11.6	Verification of Assets and Balances	11.16
11.7	Capital Adequacy	11.51
11.8	Concurrent Audit	11.67

CHAPTER 12: AUDIT OF GENERAL INSURANCE COMPANIES

12.1	Introduction	12.1
12.2	Legal Framework	12.2
12.3	Insurance Regulatory and Development Authority (IRDA) Act, 1999 and Regulations Framed thereunder	12.4
12.4	Features of Accounting System of Insurance Companies	12.4
12.5	Audit of Accounts	12.7
12.6	Specific Control Procedures related to General Insurance Business	12.11
12.7	Audit Procedures	12.12
12.8	Items Relating to Balance Sheet	12.20
12.9	Reinsurance	12.25
12.10	Co-Insurance	12.31
12.11	Solvency Margin	12.32
12.12	Trade credit insurance	12.33

CHAPTER 13: AUDIT OF CO-OPERATIVE SOCIETIES

13.1	Introduction	13.1
13.2	Auditor and Management	13.2
13.3	Special features of Co-operative Audit	13.5
13.4	Right and Duties of Co-operative Auditors	13.8
13.5	Form of Audit Report.....	13.9
13.6	Audit, Inquiry and Inspection of Multi-State Co-operative Societies	13.10

CHAPTER 14: AUDIT OF NON-BANKING FINANCIAL COMPANIES

14.1	Introduction	14.1
14.2	Audit Procedure	14.4
14.3	Classification of Frauds by NBFC	14.8
14.4	Audit Check-List	14.8
14.5	Auditor's duty.....	14.12

CHAPTER 15: AUDIT UNDER FISCAL LAWS

15.1	Introduction	15.1
15.2	Audit(s) Under the Income-Tax Act, 1961	15.1
15.3	Tax Audit under section 44AB	15.4
15.4	Audit Provisions under Vat Law	15.61

CHAPTER 16: COST AUDIT

16.1	Concept of Cost Audit	16.1
16.2	Types of Cost Audit.....	16.2
16.3	Advantages of Cost Audit	16.3
16.4	Functions of Cost Auditor	16.5
16.5	Programme of Cost Audit	16.7
16.6	Cost Audit under the Companies Act	16.9
16.7	Steps in Cost Audit	16.14
16.8	Right and Duties of Cost Auditor	16.18
16.9	True and Fair Cost of Production.....	16.18

11.1 Introduction

Lending constitutes a major activity of a bank. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

Advances generally comprises of:

- a) *money lent by the bank to its customers including interest accrued and due;*
- b) *debit balances in the account of the depositors;*
- c) *Inter-Bank Participation Certificates.*

Audit of advances is one of the most important areas covered by auditors. It is necessary that auditors should have adequate knowledge of the banking industry and the regulations governing the banks. Auditors must be aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls.

11.2 Legal Framework

There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of various types of banks are:

- ◆ Banking Regulation Act, 1949
- ◆ State Bank of India Act, 1955
- ◆ Companies Act, 2013
- ◆ State Bank of India (Subsidiary Banks) Act, 1959
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- ◆ Regional Rural Banks Act, 1976
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- ◆ Information Technology Act, 2000
- ◆ Prevention of Money Laundering Act, 2002
- ◆ Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- ◆ Credit Information Companies (Regulation) Act, 2005

11.2 Advanced Auditing and Professional Ethics

◆ Payment and Settlement Systems Act, 2007

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

11.3 Form and Content of Financial Statements

Sub-sections (1) and (2) of section 29 of the Act deal with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

11.4 Audit of Accounts

Sub-section (1) of section 30 of the Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

Qualifications of Auditor - Students may refer section 141 of the Companies Act, 2013 discussed in Chapter - 6 (The Company Audit) of this Study Material.

Appointment of Auditor - As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. In either case, approval of the Reserve Bank is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Comptroller and Auditor General of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

Remuneration of Auditor - The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

Powers of Auditor - The auditor of a banking company or of a nationalised bank, State Bank

of India, a subsidiary of State Bank of India, or a regional rural bank has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers.

Auditor's Report - In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

- (a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- (b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;
- (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- (e) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

Format of Audit Report - The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements.

In addition to matters on which he is required to report to the shareholders under the Companies Act, 2013, the auditor of a banking company is required to state in his report:

- (a) Whether or not the information and explanations required by him have been found to be satisfactory;
- (b) whether or not the transactions of the company which have come to his notice have been within the powers of the company;
- (c) whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

11.4 Advanced Auditing and Professional Ethics

(e) any other matter which he considers should be brought to the notice of the shareholders of the company.

It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report in respect of matters covered by Section 143 of the Companies Act, 2013. However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2016 is not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.

As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 the auditor's report shall also include their views and comments on the following matters, namely:

- i) whether the bank has disclosed the impact, if any, of the pending litigations on its financial position in its financial statements.***
- ii) whether the bank has made provision, as required under the law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts.***
- iii) whether there has been any delay in transferring amounts, required to be transferred to the Investment Education and Protection Fund by the bank.***

Long Form Audit Report - Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a long form audit report (LFAR). The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

The LFAR is to be submitted before 30th June every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

Reporting to RBI - The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

"If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI. In this regard, attention of the members is also invited to Clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that a chartered accountant in practice shall be deemed guilty of professional misconduct, if he

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

Under the said provision, if a member of the Institute *suo motu* discloses any information regarding any actual or possible fraud or foul play to the RBI, the member would be liable for disciplinary action by the Institute. However, a member is not held guilty under the said clause if the client explicitly permits the auditor to disclose the information to a third party. If the above-mentioned requirement of the Circular is included in the letter of appointment (which constitutes the terms of audit engagement) then it would amount to the explicit permission by the concerned bank (client) to disclose information to the third party, i.e., the RBI.

Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". The said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts.

SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Duty to report on Frauds under the Companies Act, 2013 - As per sub-section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

[Note: For detailed understanding on duty to report on fraud under Companies Act, 2013, students may refer Chapter-6 (The Company Audit) of this Study Material]

11.4.1 Conducting an Audit - The audit of banks or of their branches involves the following stages -

1. Initial consideration by the Statutory auditor
2. Identifying and Assessing the Risks of Material Misstatements
3. Understanding the Bank and Its Environment including Internal Control
4. Understand the Bank's Accounting Process
5. Understanding the Risk Management Process
6. Engagement Team Discussions

11.6 Advanced Auditing and Professional Ethics

7. Establish the Overall Audit Strategy
8. Develop the Audit Plan
9. Audit Planning Memorandum
10. Determine Audit Materiality
11. Consider Going Concern
12. Assess the Risk of Fraud including Money Laundering
13. Assess Specific Risks
14. Risk Associated with Outsourcing of Activities
15. Response to the Assessed Risks
16. Stress Testing
17. BASEL III framework.

1. Initial consideration by the statutory auditor

(i) **Declaration of Indebtedness:** The RBI has advised that the banks, before appointing their statutory central/circle/branch auditors, should obtain a declaration of indebtedness.

(ii) **Internal Assignments in Banks by Statutory Auditors:** The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.

(iii) **Planning:** Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement; and

(b) ***Establish understanding of terms of engagement as per SA 210, "Agreeing the Terms of Audit Engagements"***

(iv) **Communication with Previous Auditor:** As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing.

(v) **Terms of Audit Engagements:** SA 210, "Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit relationship.

(vi) **Initial Engagements:** The auditor needs to perform the audit procedures as mentioned in SA 510 "Initial Audit Engagements-Opening Balances" and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is

not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

(vii) Assessment of Engagement Risk: The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

(viii) Establish the Engagement Team: The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank's operations.

(ix) Understanding the Bank and its Environment: SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

2. Identifying and Assessing the Risks of Material Misstatements: SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.

3. Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- ◆ to identify and assess risk;
- ◆ to develop an audit plan so as to determine the operating effectiveness of the controls, and to address the specific risks.

4. Understand the Bank's Accounting Process: The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.

5. Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- ◆ *Oversight and involvement in the control process by those charged with governance:* Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

11.8 Advanced Auditing and Professional Ethics

- ◆ *Identification, measurement and monitoring of risks:* Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
 - ◆ *Control activities:* A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.
 - ◆ *Monitoring activities:* Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
 - ◆ *Reliable information systems:* Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.
- 6. Engagement Team Discussions:** The engagement team should hold discussions to gain better understanding of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.
- 7. Establish the Overall Audit Strategy:** SA 300 "Planning an Audit of financial Statements" states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:
- ◆ establish the overall audit strategy, prior to the commencement of an audit; and
 - ◆ involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.
- 8. Develop the Audit Plan:** SA 300 deals with the auditor's responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit. Before starting the planning of an audit, the auditor must perform the procedures as defined under SA 220, "Quality Control for an Audit of Financial Statements" for reviewing the ethical and independence requirements. In addition to this, the auditor is also required to comply with the requirements of SA 210, "Agreeing the Terms of Audit Engagement".
- 9. Audit Planning Memorandum:** The auditor should summarise their audit plan by preparing an audit planning memorandum in order to:
- ◆ Describe the expected scope and extent of the audit procedures to be performed by the auditor.
 - ◆ Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
 - ◆ Provide evidence that they have planned the audit engagement appropriately and have

responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

10. Determine Audit Materiality: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment and depends upon the knowledge of the bank, assessment of engagement risk, and the reporting requirements for the financial statements.

11. Consider Going Concern: In obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

12. Assess the Risk of Fraud including Money Laundering: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective are to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

13. Assess Specific Risks: The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions.

14. Risk Associated with Outsourcing of Activities: The modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

15. Response to the Assessed Risks: SA 330 "The Auditor's Responses to Assessed Risks" requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

16. Stress Testing: RBI has required that all commercial banks shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

17. BASEL III framework: The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of

11.10 Advanced Auditing and Professional Ethics

instruments in the new definition of regulatory capital.

[**Note:** For detailed understanding of stages involved for conducting an audit, as discussed above, students may refer Guidance Note on Audit of Banks.]

Demonetisation

On 8th November, 2016, the Government announced Demonetisation Program by declaring withdrawal of legal tender status to currency notes denomination of ₹. 1000 and ₹. 500 (herein referred as Specified Bank Notes (SBN)) effective from November 09, 2016. Consequent to the announcement, there have been a series of announcements and notifications by the RBI regarding exchange facility, withdrawal limit, etc.

The most important aspect of Demonetisation program is to reconcile the balance of SBN and its movement by banks to ensure no misuse by branch officials. Reporting of the said details by banks has also been prescribed.

11.4.2 Special Considerations in a CIS Environment - As in today's environment all banks have embarked upon a large scale computerization, this has resulted in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. Thus, while the overall objective and scope of audit do not change simply because data is maintained on computers, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and the nature, timing and extent of his other audit procedures are affected in a CIS environment.

11.4.3 Internal Audit and Inspection - Banks generally have a well organised system of internal audit. Their internal auditors pay frequent visit to the branches. They are an important link in the internal control of the bank. The systems of internal audit in different banks also have a system of regular inspection of branches and head office. The internal audit and inspection function is carried out by a separate department within the bank by firms of chartered accountants.

11.5 Internal Control in Certain Selected Areas

11.5.1 General

- (a) The staff and officers of a bank should be shifted from one position to another frequently and without prior notice.
- (b) The work of one person should always be checked by another person (usually by an officer) in the normal course of business.
- (c) The arithmetical accuracy of the books should be proved independently every day.
- (d) All bank forms (e.g. Cheque books, demand draft books, travellers' cheques etc.) should be kept in the possession of an officer, and another responsible officer should occasionally verify the stock of such stationery.

- (e) The mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.
- (f) The signature book and the telegraphic code book should be kept with responsible officers and used and seen by authorised officers only.
- (g) The bank should take out insurance policies against loss and employees' infidelity.
- (h) The powers of officers of different grades should be clearly defined.
- (i) There should be surprise inspection of head office and branches at periodic interval by the internal audit department. The irregularities pointed out in the inspection reports should be promptly rectified.

11.5.2 Cash

- (a) Cash should be kept in the joint custody of two responsible officers.
- (b) In addition to normal checking by the chief cashier, cash should be test-checked daily and counted in full occasionally by a responsible officer unconnected with the cash department. Actual cash in hand should agree with the balance shown by the Day Book every day.
- (c) The cashier should have no access to the customer's ledger accounts and the Day Book. This is an important safeguard. Bank managements are often tempted to use cashiers because of their shorter working hours as ledger clerks in the absence of regular staff on leave, etc. This can be a very expensive price of economy.
- (d) The counterfoil cash receipt vouchers (e.g. counterfeits of pay-in-slips lodged by the depositors) should be signed by an officer in Cash Department, in addition to the receiving cashier.
- (e) Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.) have been passed for payment by the proper officer and have been entered in the customer's account.
- (f) Receipt and payment scrolls or their totals should be compared with the cash column of the Day-Book by independent persons.
- (g) Where the teller system is prevalent-
 - (i) A limit should be placed on the powers of tellers to make payment.
 - (ii) All vouchers relating to the accounts of customers which the tellers handle should first be sent to them and entered by them in the ledger cards.
 - (iii) Total payment made by a teller should be reconciled with the cash columns of the Voucher Summary Sheet of the ledger concerned every day.
 - (iv) There should be frequent rotation of tellers.

11.5.3 Clearings

- (a) Cheques received by the bank in clearing should be checked with the list accompanying them. Independent list should be prepared for cheques debited to different customers

11.12 Advanced Auditing and Professional Ethics

accounts and those returned unpaid and these should be checked by officers. The total number and amount of cheques included in these lists should be agreed with the list first mentioned by a person unconnected with both the customers, ledgers and the clearing department.

(b) The total number and amount of cheques sent out by the bank for clearing should be agreed with the total of the clearing pay- in-slips, by an independent person.

(c) The unpaid cheques received back in return clearing should be checked in the same manner as the cheques received.

11.5.4 Constituents' Ledgers

(a) Before making payment, cheques should be properly checked in respect of signature, date, balance in hand etc. and should be passed by an officer and entered into constituents' accounts.

(b) No withdrawals should normally be allowed against clearing cheques deposited on the same day.

(c) An officer should check all the entries made in the ledger with the original documents particularly noting that the correct accounts have been debited or credited.

(d) Ledger keepers should not have access to Voucher Summary Sheet after they have been checked by an officer and to the Day Book.

(e) Interest debited or credited to constituents' accounts should be independently checked.

11.5.5 Bills for Collection

(a) All the documents accompanying the bills should be received and entered in the Register by a responsible officer. At the time of despatch, the officer should also see that all the documents are sent along with the bills.

(b) The accounts of customers or principals should be credited only after the bills have been collected or an advice to that effect received from the branch or agent to which they were sent for collection.

(c) It should be ensured that bills sent by one, branch for collection to another branch of the bank, are not taken in the bills for collection twice in the amalgamated balance sheet of the bank. For this purpose, the receiving branch should reverse the entries regarding such bills at the end of the year for closing purposes.

11.5.6 Bills Purchased

(a) At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank.

(b) Sufficient margin should be kept while purchasing or discounting a bill so as to cover any decline in the value of the security etc.

(c) If the bank is unable to collect a bill on the due date, immediate steps should be taken to recover the amount from the drawer against the security provided.

- (d) All irregular outstanding accounts should be reported to the Head Office.
- (e) In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.

11.5.7 Loans and Advances

- (a) The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
- (b) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- (c) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or for particular accounts.
- (d) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
- (e) All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.
- (f) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
- (g) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
- (h) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
- (i) As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.
- (j) All accounts should be kept within both the drawing power and the sanctioned limit at all times.
- (k) All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.
- (l) The operation (in each advance should be reviewed at least once every year.)

11.5.8 Telegraphic Transfers and Demand Drafts

- (a) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.
- (b) The signatures on a demand draft should be checked by an officer with the Signature Book.

11.14 Advanced Auditing and Professional Ethics

(c) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.

(d) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

11.5.9 Inter Branch Accounts

(a) The accounts should be adjusted only on the basis of advices (and not on the strength of entries found in the statement of account) received from other branches,

(b) Prompt action should be taken preferably by central authority, if any entries (particularly debit entries) are not responded to by any branch within a reasonable time.

11.5.10 Credit Card Operations

(a) There should be effective screening of applications with reasonably good credit assessments.

(b) There should be strict control over storage and issue of cards.

(c) There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

(d) There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.

(e) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.

(f) All the reimbursement (gross of commission) should be immediately charged to the customer's account.

(g) There should be a system to ensure that statements are sent regularly and promptly to the customer.

(h) There should be a system to monitor and follow-up customers' payments.

(i) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.

(j) There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

11.5.11 Compliance with CRR and SLR requirements

1. Cash Reserve Ratio (CRR) Requirements - One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a certain minimum cash reserve. While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation

Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934. The RBI, from time to time, reviews the evolving liquidity situation and accordingly decides the rate of CRR required to be maintained by scheduled commercial banks. Therefore, the auditor need to refer the master circular issued from time to time in this regard to ensure the compliance of CRR requirements.

2. Statutory Liquidity Ratio (SLR) Requirements - The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the top management of the bank and to the Reserve Bank. The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:

- (i) correctness of the compilation of DTL (Demand and Time Liabilities) position; and
- (ii) maintenance of liquid assets.

Audit approach and procedure:

- (i) Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.
- (ii) Require the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.
- (iii) Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.
- (iv) While examining the computation of DTL, specifically examine that the following items have been excluded from liabilities-
 - (a) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
 - (b) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.
 - (c) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
 - (d) Margins held and kept in sundry deposits for funded facilities.
- (v) Similarly, specifically examine that the following items have been included in liabilities-

11.16 Advanced Auditing and Professional Ethics

- (a) Net credit balance in branch adjustment accounts including these relating to foreign branches.
- (b) Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.
- (c) ***Borrowings from abroad by banks in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'***
- (d) ***The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.***
- (vi) ***Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches.***
- (vii) ***It may be noted that, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL.***
- (viii) ***The auditor at the central level should apply the audit procedures listed above to the overall consolidation prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in his report.***
- (viii) While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion. ***Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this.***

11.6 Verification of Assets and Balances

The following are the steps involved in verification of assets and balances-

I. CASH, BANK BALANCES AND MONEY AT CALL AND SHORT NOTICE - The Third Schedule to the Banking Regulation Act, 1949, requires the following disclosures to be made in the balance sheet regarding cash, balances with RBI, balances with other banks, and money at call and short notice.

Cash and Balances with Reserve Bank of India

- I. Cash in hand (including foreign currency notes)
- II. Balances with Reserve Bank of India
 - (i) in Current Account

- (ii) in Other Accounts

Balances with Banks and Money at Call and Short Notice

I. In India

- (i) Balances with other banks
 - (a) in Current Accounts
 - (b) in Other Deposit Accounts
- (ii) Money at call and short notice
 - (a) with banks
 - (b) with other institutions

II. Outside India

- (i) in Current Accounts
- (ii) in Other Deposit Accounts
- (iii) Money at call and short notice

Audit Procedures:

(a) Cash - The auditor should count the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible. It is sometimes arranged by the branch to deposit a large portion of its cash balance with the Reserve Bank of India or the State Bank of India or any other bank on the closing day, in which case, the work of the auditor is reduced substantially.

The cash balance as physically verified should be agreed with the balance shown in the cash book and the cash balance book. When the physical verification of cash is carried out by the auditor before or after the date of the balance sheet, the auditor should work forward/backward (as the case may be) to reconcile the results of his verification with the cash balance at the balance sheet date as shown by the books.

(b) Balance with Reserve Bank of India - In a bank, only a few select branches are designated to have account with the Reserve Bank. Thus, this item would not appear in the balance sheet of every branch. The following procedures are therefore applicable only to branches having account with the Reserve Bank of India.

- * Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
- * Review the reconciliation statements. He should pay special attention to the following items appearing in the reconciliation statements:
 - (i) Cash transactions remaining unresponded;

11.18 Advanced Auditing and Professional Ethics

- (ii) Revenue items requiring adjustments/write-offs; and
- (iii) Old outstanding balances remaining unexplained / unadjusted for over one year.

* Obtain a written explanation from the management as to the reasons for old outstanding transactions in bank reconciliation statements remaining unexplained / unadjusted for over one year.

(c) Balance with Banks (Other than Reserve Bank of India) - Apart from the procedures described above in examining the balances with banks other than Reserve Bank, while reviewing the reconciliation statements, the auditor should pay particular attention to the following.

- (i) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken.
- (ii) Examine that no cheque sent or received in clearing is outstanding.
- (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

The balances with banks outside India should also be verified in the manner described above. These balances should be converted into the Indian currency at the exchange rates prevailing on the balance sheet date.

(d) Money at Call and Short Notice - Money at call and short notice represents short-term investment of surplus funds in the money market. Money lent for one day is money at 'call' while money lent for a period of more than one day and up to fourteen days is money at 'short notice'.

The auditor should examine whether there is a proper authorisation, general or specific, for lending of the money at call or short notice. Compliance with the instructions or guidelines laid down in this behalf by the head office or controlling office of the branch, including the limits on lendings in inter-bank call money market, should also be examined.

Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. The auditor should examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. He should also examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted-off against call loans received.

II. INVESTMENTS - The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of investments in the balance sheet as follows:

- I. *Investments in India in*
 - (i) Government securities
 - (ii) Other approved securities
 - (iii) Shares
 - (iv) Debentures and Bonds
 - (v) Subsidiaries and/or joint ventures

(vi) Others (to be specified)

II. *Investments outside India in*

- (i) Government securities (including local authorities)
- (ii) Subsidiaries and/or joint ventures abroad
- (iii) Other investments (to be specified)

In addition to other disclosures regarding investments, the Notes and Instructions for Compilation of Balance Sheet, also require the following information to be disclosed in the balance sheet:

- (1) gross value of investments in India and outside India;
- (2) aggregate of provisions for depreciation, separately on investments in India and outside India; and
- (3) net value of investments in India and outside India.
- (4) movement of provisions held towards depreciation on investments including opening balance by adding provisions made during the year and after deducting write-off/ write-back of excess provisions during the year.

The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The break-up of net value of investments in India and outside India (gross value of investments less provision) under each of the specified category need only be shown.

Audit Procedures: The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments in as much as non-compliance may have a direct and material affect on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditor should keep this in view while designing his audit procedures relating to investments.

(a) Internal Control Evaluation and Review of Investment Policy: The auditors should familiarise themselves with the instructions issued by the RBI regarding transactions in securities. They should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank. While examining the internal controls over investments (including those on SGL forms and BRs), the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI. He should also judge their efficacy.

(b) Separation of Investment Functions: The auditor should also examine whether the bank, as required by the RBI, is maintaining separate accounts for the investments made by it on their own Investment Account, on PMS clients' account, and on behalf of other constituents (including brokers). As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.

11.20 Advanced Auditing and Professional Ethics

(c) Examination of Reconciliation: The auditor should examine the reconciliation of the investment account, physically verify the securities on hand, obtain confirmations from counter-party banks for BRs issued by such banks and on hand, obtain confirmation of SGL balances with the PDO, and examine the control and reconciliation of BRs issued by the bank.

(d) Examination of Documents: The auditor should ascertain whether the investments made by the bank are within its authority. In this regard, the auditor should examine whether the legal requirements governing the bank, in so far as they relate to investments, have been complied with and the investments made by the bank are not *ultra virus* the bank. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the bank.

The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. ***The auditors should also check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades, and accounting of the same (generally termed as front office, middle office and back office functions' segregation).***

(e) Physical Verification: The auditor should verify the investment scrips physically at the close of business on the date of the balance sheet. In exceptional cases where it is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc.

In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organisation.

In respect of BRs issued by other banks and on hand with the bank at the year-end, the auditor should examine confirmations of counterparty banks about such BRs. Where any BRs have been outstanding for an unduly long period, the auditor should obtain written explanation from the management for the reasons thereof. The auditor should examine the reconciliation of BRs issued by the bank.

If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and also an undertaking from them that they hold the securities on behalf of the bank.

(f) Examination of Valuation: Method of valuation of investments followed by a bank may, therefore, have a significant effect on its balance sheet and profit and loss account. The auditor should examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments in the context of the guidelines of the RBI and the accounting policy followed by the bank in respect of investments. The auditor should examine the appropriateness of accounting policies followed

by the bank. In case any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report. In this regard, it may be noted that Accounting Standard (AS) 13, "Accounting for Investments", does not apply to banks.

According to RBI guidelines, in respect of shares which are unquoted or for which current quotations are not available, the market value has to be determined on the basis of the latest balance sheet of the company. This might create a problem in the case of new companies whose first annual reports are not yet available. It appears that in such a situation, it would be appropriate to value the shares at cost except where the evidence available indicates the deterioration in the value.

RBI guidelines require that individual scrips in the available-for-sale category should be marked to market at quarterly or more frequent intervals. It is further required that net depreciation in respect of each of the categories in which investments are presented in the balance sheet should be provided for while any similar net appreciation should be ignored. **As regards the scrips in Held for Trading (HFT) category, the same should be marked to market at monthly or at more frequent intervals in the similar manner, except in the following cases:**

- (i) **Equity shares should be marked to market preferably on daily basis, but at least on a weekly basis;**
- (ii) **Banks which undertake short sale transactions, the entire HFT portfolio including the short position should be marked to market on daily basis.**

The auditor should examine whether the profit or loss on sale of investments has been computed properly. **The carrying amount of investments disposed off should be determined consistently on similar basis. In case of HTM investments, Net Profit on sale of investments in this category should be first taken to the Profit & Loss Account, and thereafter be appropriated to the 'Capital Reserve Account' net of taxes and Net Loss will be recognised in the Profit & Loss Account.**

The classification of investments into held-to-maturity, held-for-trading and available-for-sale categories is based on the intention with which the respective investments have been acquired by the bank. The auditor should examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by the decision of the competent authority such as Board of directors, ALCO or Investment Committee.

As per RBI guidelines, investments classified under held-for-trading category should be sold within 90 days of their acquisition, failing which they should be shifted to the available-for-sale-category. The auditor should accordingly ensure that no investments purchased more than 89 days before the balance sheet date have been classified under this category.

Subject to what is stated above, the auditor should examine compliance by the bank with the guidelines of the RBI relating to valuation of investments.

11.22 Advanced Auditing and Professional Ethics

The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/on line medium.

There may be cases where the certificates of tax deduction at source (TDS) received along with the dividend/interest on investments are found missing. This increases the incidence of tax on the bank. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the bank.

Special-purpose Certificates Relating to Investments: It may be noted that pursuant to RBI's circulars, issued from time to time, banks require their central auditors to issue the following certificates regarding investments of the bank (in addition to their main audit report and the long form audit report)-

- (i) Certificate on reconciliation of securities by the bank (both on its own Investment Account as well as PMS clients' account). The reconciliation is to be presented in a given format.
- (ii) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the Reserve Bank of India.

(g) Dealings in Securities on Behalf of Others: Apart from making investments on its account, a bank may also deal in securities on behalf of its customers only with the prior approval from RBI. These activities of banks are in the nature of trust or fiduciary activities.

The auditor should examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.

(h) Examination of classification and shifting: The auditor should examine whether the shifting of the investments from 'available for sale' to 'held to maturity' is duly approved by the Board of Directors of the bank. The auditor should also ensure the compliance of the RBI guidelines, issued from time to time, in this regard.

Audit, Review and Reporting: Banks should undertake half-yearly reviews (as of 30th September and 31st March) of their investment portfolio. These half yearly reviews should not only cover the operational aspects of the investment portfolio but also clearly indicate amendments made to the investment policy and certify the adherence to laid down internal investment policy and procedures and RBI guidelines.

The internal auditors are required to separately conduct the concurrent audit of treasury transactions and the results of their report should be placed before the CMD once every month. Banks need not forward copies of the audit report of internal auditor to RBI. However, major irregularities observed in these reports and position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

Classification of Investments: Banks are required to classify their entire investments portfolio into three categories-

- (i) *Held-to-maturity (HTM):* This category would comprise securities acquired by the bank

with the intention to hold them up to maturity.

- (ii) *Held-for-trading (HFT)*: This category would comprise securities acquired by the bank with the intention of trading, i.e., to benefit from short-term price/interest rate movements.
- (iii) *Available-for-sale (AFS)*: This category will comprise securities, which do not qualify for being categorised in either of the above categories, i.e., those that are acquired neither for trading purpose nor for being held till maturity.

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposal/deal slip.

Non-Performing Investments: A non performing investment (NPI), similar to a non-performing advance (NPA), is one where-

- (i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at ₹ 1 per company on account of the non-availability of the latest balance sheet.
- (iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and vice versa. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA.
- (v) The investments in debentures/bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.
- (vi) In case of conversion of non-performing loans into equity, debentures, bonds, etc., such instruments should be treated as NPI ab-initio in the same asset classification in which the relevant non-performing loans were classified and provision should be made as per the norms.

The guidelines specified above for identification of NPI will apply to state government guaranteed securities also.

Bank should make appropriate provisions for such NPIs by way of depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

Income Recognition: The banks may book income in the following manner-

- (i) Banks may book income on accrual basis on securities of corporate bodies/ public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.

11.24 Advanced Auditing and Professional Ethics

- (ii) Banks may book interest income from all other performing investments on accrual basis provided interest rates on these instruments are pre-determined.
- (iii) Discount earned on discounted instruments like commercial papers, zero coupon bonds should be booked on accrual basis. The discount may either be accrued equally over the remaining period to maturity or by following the constant yield method.
- (iv) Interest income from non-performing investments should be booked on realisation.
- (v) Dividend on shares may be booked on accrual basis provided it is approved by the corporate body in its Annual General Meeting and the owner's right to receive dividend is established.
- (vi) Income from units of mutual funds should be booked on cash basis.
- (vii) Discount on interest bearing government securities classified under HTM should be recognised on redemption of the investments and should not be amortised over the remaining period to maturity.
- (viii) Profit and loss on sale of investments including on HTM category, should be shown under Profit/Loss on sale of investments.
- (ix) In case of sale of investments acquired on conversion of loan, if the sale proceeds are higher than the net book value, the excess to the extent of provision will not be reversed but will be utilised to meet the shortfall / loss on account of sale of other financial assets to SC /RC.
- (x) Except for profit/loss on sale/revaluation of investment, provision for investments and dividend from subsidiaries and joint ventures, all other income from investments should be shown under the head income from investment.

III. Advances - The Third Schedule to the Act requires classification of advances made by a bank from three different angles, viz., nature of advance, nature and extent of security, and place of making advance (i.e. whether in India or outside India). Accordingly, the advances are to be classified in Schedule 9 to the balance sheet as follows:

- A.
 - (i) Bills purchased and discounted
 - (ii) Cash Credits, Overdrafts and Loans repayable on demand
 - (iii) Term loans
- B.
 - (i) Secured by tangible assets
 - (ii) Covered by bank/government guarantees
 - (iii) Unsecured
- C.
 - I. Advances in India
 - (i) Priority sectors
 - (ii) Public sector
 - (iii) Banks
 - (iv) Others

- II. Advances outside India
 - (i) Due from banks
 - (ii) Due from others
 - (iii) Bills purchased and discounted
 - (iv) Syndicated loans
 - (v) Others

Non-Performing Assets: An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

Criteria for Classification of Various Types of Credit Facilities: In line with the international best practices and to ensure greater transparency, the RBI has directed the banks to adopt the '90 days' overdue' norm for identification of NPAs from the year ending March 31, 2004.

Banks have been charging interest at monthly rests, from April 1, 2002. However, the banks were advised that the date of classification of an advance as NPA would not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'. Further, any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

The following criteria are to be applied for determining the status of various types of credit facilities:

- (a) *Term Loans:* A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.
- (b) *Cash Credits and Overdrafts:* A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.
- (c) *Bills Purchased and Discounted:* Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.
- (d) *Securitisation:* The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- (e) *Agricultural Advances:* A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

As per the guidelines, "long duration" crops would be crops with crop season longer than

11.26 Advanced Auditing and Professional Ethics

one year and crops, which are not “long duration” crops would be treated as “short duration” crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers’ Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors. In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

- (f) *Credit Card Accounts:* RBI vide its Circular on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Credit Card Accounts” advised that a credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month. It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies and for the purpose of levying of penal charges, viz., late payment charges, etc., if any.

Classification Norms relating to NPAs

Temporary Deficiencies: In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

- (a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.
- (b) The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- (c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.
- (d) The accounts where regular/*ad hoc* credit limits have not been reviewed/renewed within 180 days from the due date/date of *ad hoc* sanction, the account should be treated as NPA.

Regularisation Near About Balance Sheet: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.

Asset Classification to be Borrower-wise not Facility-wise: All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA/NPI and not the particular investment/facility once any or a part of the facility/investment has become irregular.

Erosion in Value of Securities/ Frauds Committed by Borrowers: In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate. Further,

- (i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as “significant”, requiring the asset to be classified as doubtful straightaway and provided for adequately.
- (ii) The realisable value of security as assessed by bank/approved valuers/RBI is less than 10% of the outstanding in the borrowal accounts, the existence of the security should be ignored and the asset should be classified as loss asset. In such cases the asset should either be written off or fully provided for.

Government Guaranteed Advances: The credit facilities backed by guarantees of central government though overdue may be treated as NPA only when the government repudiates its guarantee when invoked. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income. In case of State Government guaranteed loans, this exemption will not be available and such account will be NPA if interest / principal / other dues remain overdue for more than 90 days.

Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.: Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

Agricultural Advances Affected by Natural Calamities: Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short term loan, subject to the guidelines contained in RBI’s latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. In such cases, the NPA classification would be governed by such rescheduled terms.

Advances to Staff: Interest bearing staff advances as a banker should be included as part of

11.28 Advanced Auditing and Professional Ethics

advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

Income Recognition

On Advances Granted: Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realised should be reversed or provided for. Further,

- i. Interest income on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- ii. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.
- iii. If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Reversal of Income: If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

On Leased Assets: The finance charge component of finance income [as defined in 'AS 19 – Leases] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out Finance: In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs: In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

[**Note:** For classification of advances, provisioning norms, etc., students may refer Chapter 6 of Paper 5- Advanced Accounting, Intermediate (IPC) Study Material.]

Auditor's Report in Case of Bank Borrowers: The RBI vide its circular had prescribed that all borrowers having credit limit of ₹ 10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. The RBI has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

Audit Procedures - Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- b. Advances represent amount due to the bank.
- c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- d. There are no unrecorded advances.
- e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- ◆ examining the validity of the recorded amounts;
- ◆ examining loan documentation;

11.30 Advanced Auditing and Professional Ethics

- ◆ reviewing the operation of the accounts;
- ◆ examining the existence, enforceability and valuation of the security;
- ◆ checking compliance with RBI norms including appropriate classification and provisioning; and
- ◆ carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls. What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch. As a general rule, however, an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- ◆ The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It also needs to be ensured that the loans sanctioned are as per the Loan Policy of the bank and adhere to the regulatory (RBI) norms unless a specific exemption is taken in this regard.
- ◆ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- ◆ The compliance with the terms of sanction and end use of funds should be ensured.
- ◆ Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- ◆ If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- ◆ All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- ◆ In the case of goods in the possession of the bank, contents of the packages should be

test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.

- ◆ Surprise checks should be made in respect of hypothecated goods not in the physical possession of the bank.
- ◆ ***Drawing Power Register should be updated every month to record the value of securities hypothecated.*** These entries should be checked by an officer.
- ◆ The accounts should be kept within both the drawing power and the sanctioned limit.
- ◆ All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- ◆ The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

Long Form Audit Report: The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report. Thus, he should examine, *inter alia*, whether the loan applications are complete and in prescribed form; procedural instructions regarding grant/ renewal/ enhancement of facilities have been complied with; sanctions are within delegated authority and disbursements are as per terms of the sanction; documentation is complete; and supervision is timely, effective and as per prescribed guidelines. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases. The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

Examining the Validity of Recorded Amounts: The auditor should ascertain the status of balancing of subsidiary ledgers relating to advances. The total of balances in the subsidiary ledgers should agree with the control accounts in the General Ledger. The auditor should also tally the total of the statement of advances with the balances as per general ledger/ subsidiary ledgers. He should also cross-check the balances of the advances selected for examination as listed in the statement of advances with the balances in the relevant advance accounts in the subsidiary ledgers. Banks often obtain balance confirmation statements from borrowers periodically. Such statements have a dual advantage in preventing disputes by the customer and extending the period of limitation by reference to the date of confirmation. Wherever available, such confirmations may be seen.

These days most of the banks have their 'advances' statements generated through the system. The auditor should ensure that the fields which system copies from last year are the same and he should take extra care in relation with the date of NPA and date of becoming doubtful asset as these facts have great bearing on the provisioning. The auditor should obtain audit trail from the bank to verify whether there are any changes or not.

Examination of Loan Documents: As indicated earlier, the documents relating to advances

11.32 Advanced Auditing and Professional Ethics

would be affected by the legal status of the borrower and the nature of security. Thus, where the borrower is a company, loan documents would include certificate of incorporation, memorandum and articles of association, certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and resolution of shareholders [in cases covered by section 180 of the Companies Act, 2013], etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. The formats of many of the documents are also prescribed. The auditor should evaluate the adequacy of the loan documents in the context of the rules framed by the bank in this regard.

Review of Operation of Account: The auditor should review the operation of the advance accounts. In doing so, an intelligent scrutiny of the operation of the account should be carried out to see that the limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.

The auditor should also examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into, to identify any irregularities in these accounts. A written note/explanation may be obtained from the management as regards any major irregularities which may have a bearing on his report.

The auditor may also review the following to assess the recoverability of advances:

- (a) Periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
- (b) Latest financial statements of borrowers.
- (c) Reports on inspection of security.
- (d) Auditors' reports in the case of borrowers enjoying aggregate credit limits of ₹ 10 lakh or above for working capital from the banking system.

The auditor should satisfy himself that interest is being charged on all performing accounts regularly. He should compare the rate of interest with the agreement and the sanction and with the credit rating reports where the rate of interest is linked to credit rating. In case the interest rate is to be revised based on the changes in PLR/BPLR/Base rate of the bank, it needs to be ensured that the rate of interest to be charged from the borrower is suitably revised as and

when there are changes in PLR/BPLR/Base rate. Calculation of interest should be test-checked. The auditor should examine that interest not received on any account, which is a non-performing asset as per the guidelines of the RBI, has not been recognised as income. It may be noted that interest accrued but not due on advances does not form part of advances.

Verification of Security against Advances: From the view point of security, advances are to be classified in the balance sheet in the following manner:

- (a) Secured by tangible assets
- (b) Covered by bank/government guarantees
- (c) Unsecured

An advance should be treated as secured to the extent of the value of the security on the balance sheet date. If only a part of the advance is covered by the value of the security as at the date of the balance sheet, that part only should be classified as secured; the remaining amount should be classified as unsecured.

As mentioned earlier, the Reserve Bank has specified that advances against book debts may be included under the head 'secured by tangible assets'.

The following points are relevant for classifying the advances based on security.

- (a) Government guarantees include guarantees of Central/State Governments and also advances guaranteed by Central/State Government owned corporations and financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial Development Corporations, ECGC, DICGC, etc.
- (b) Advances covered by bank guarantees also include advances guaranteed against any negotiable instrument, the payment of which is guaranteed by a bank.
- (c) Advances covered by bank/government guarantees should be included in unsecured advances to the extent the outstanding in these advances exceed the amount of related guarantees.
- (d) While classifying the advances as secured, the primary security should be applied first and for the residual balance, if any, the value of collateral security should be taken into account. If the advance is still not fully covered, then, to the extent of bank/government guarantees available, the advance should be classified as 'covered by bank/government guarantee'. The balance, if any, remaining after the above classification, should be classified as 'unsecured'.
- (e) There may be situations where more than one facility is granted to a single borrower and a facility is secured, apart from primary and collateral securities relating specifically to that facility, by the residual value of primary security relating to any other credit facility (or facilities) granted to the borrower. In such a case, in the event of shortfall in the value of primary security in such a credit facility, the residual value of primary security of the other facility (or facilities, as the case may be) may be applied first to the shortfall and the value of collateral securities should be applied next.
- (f) In the case of common collateral security for advances granted to more than one borrower, if there is a shortfall in value of primary security in any one or more of the

11.34 Advanced Auditing and Professional Ethics

borrowal accounts, the value of collateral security may be applied proportionately to the shortfall in each borrowal account.

- (g) Advances covered by ECGC/DICGC guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC and kept in sundry creditors account pending adjustment should be deducted from advances.
- (h) An account which is fully secured but the margin in which is lower than that stipulated by the bank should nevertheless be treated as fully secured for the purposes of balance sheet presentation.
- (i) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as 'secured'.
- (j) Documentary bills under delivery-against-acceptance terms which remain unaccepted as at the close of 31st March (i.e., for which the documents of title are with the bank on this date) should be classified as secured. All accepted bills should be classified as 'unsecured' unless collaterally secured.
- (k) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.
- (l) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.
- (m) 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc.

In examining whether an advance is secured and, if so, to what extent, the auditor is concerned with determining –

- (a) whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with;
- (b) whether the security is in the effective control of the bank; and
- (c) to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.

The auditor should examine the following aspects in respect of advances classified as 'secured':

- (a) Documents executed are complete and in force.
- (b) Where documents have not been renewed, the limitation period has not expired.
- (c) Evidence is available as to the market value of the security.
- (d) Evidence is available that –
 - (i) hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;

- (ii) advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and
- (iii) Stocks hypothecated/pledged are paid stocks owned by the borrower.
- (e) In the case of companies, the charge is appropriately registered with the Registrar of Companies and a certificate of registration of charge or other evidence of registration is held.
- (f) Borrowers are regular in furnishing the requisite information regarding the value of security lodged with the bank.
- (g) In respect of the second charge being available in respect of certain assets, the amount of the lender(s) enjoying the first charge on such asset be worked out and only the residuary value, if any, available for second charge holders, be considered.

The following paragraphs deal with the different types of securities against advances generally accepted by banks and the manner in which the auditor should verify them.

Stock Exchange Securities and Other Securities: The auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. The auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required and verify the same with Demat Account.

It sometimes happens that a quoted security may not have frequent transactions on the stock exchange and the quotation included in the official quotations may be that of a very old transaction. In such a case, the auditor should satisfy himself as to the market value by scrutiny of balance sheet, etc., of the company concerned, particularly if the amount of advance made against such security is large.

Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been paid in time by the borrower/bank.

Goods: In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank's security is only to the extent of the latter. Auditor should also verify that the Bank has system of maintenance of proper register in this regard as also system of scrutiny of stock/book debt statement furnished by the borrower.

In respect of goods pledged with the bank, the auditor should check the statement received from the borrower regarding the quantity and value of goods pledged by him. He should test check the godown registers and the valuation of the goods. If there is any outstanding delivery order against the goods as on the balance sheet date, the same should be deducted from the total quantity in hand in ascertaining the value of the goods constituting the security. The auditor may also examine the key movement register to verify the movement of goods inwards and/or outwards.

Sometimes, goods are in the possession of third parties, such as clearing and forwarding

11.36 Advanced Auditing and Professional Ethics

agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor.

In case the borrower is a company, the auditor should examine the certificate of registration of charge on the goods hypothecated with the Registrar of Companies. It may be mentioned that in case of pledge of goods, registration of charge is not necessary.

Gold Ornaments and Bullion: The auditor should inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold.

In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact. The weights mentioned on the bars may generally be accepted as correct.

Life Insurance Policies: The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer. The auditor should also examine whether premium has been paid on the policies and whether they are in force. Certificate regarding surrender value obtained from the insurer should be examined. The auditor should particularly see that if such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

Bank's Own Deposit Certificates: The auditor should inspect such certificates and examine whether they have been properly discharged and whether the lien of the bank is noted on the face of the certificates as well as in the relevant register of the bank.

Hire-purchase Documents: These advances may be classified as secured against the hypothecation of goods. Where there is no hypothecation, the advance will be classified as unsecured.

Plantations: These advances are classified as secured against the crop and/or the fixed assets of the plantation. The auditor should examine the agreement and the title deeds. Regarding the estimate of the crop, he may examine the record of the garden for the last few years. He should also ascertain whether the crop is properly insured against natural calamities and other disasters such as hail, etc.

Auditor should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interests becomes due only after the moratorium or gestation period is over and in such a case the account will become NPA in case interest is not recovered after the due date of such interest after moratorium period, if specifically mentioned in the sanction letter.

Immovable Property: The auditor should inspect the title deed, the solicitor's opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely upon the architect's or valuer's report (which should be taken at least once in three years) after carrying

out appropriate audit procedures to satisfy himself about the adequacy of the work of the architect/valuer for his purpose.¹ He should also examine the insurance policies.

In some cases, banks make advances against immovable properties where the title deeds are not in the name of the borrower. For example, an advance may be given against the security of a flat in a co-operative group housing society, the title deeds of which may not be in the name of the borrower. In such cases, the auditor should examine the evidence regarding the right or interest of the borrower in the property mortgaged, e.g., power of attorney, share certificate of co-operative group housing society, 'no objection certificate' from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

Reliance on / review of other reports: The auditor should take into account the adverse comments, if any, on advances appearing in the following-

- ◆ Previous audit reports.
- ◆ Latest internal inspection reports of bank officials.
- ◆ Reserve Bank's latest inspection report.
- ◆ Concurrent / Internal audit report.
- ◆ Report on verification of security.
- ◆ Any other internal reports specially related to particular accounts.
- ◆ Manager's charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

Third Party Guarantees: The auditor should examine the guarantee bonds and the demand promissory notes in order to verify the third party liability. He should satisfy himself that the guarantee is in force as at the date of the balance sheet. In the absence of a provision to the contrary, a guarantee terminates by revocation or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for composition, or agrees to give time or agrees not to sue him, without consulting the surety. If any variation is made in the terms of the contract between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation. The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies.

Verification of Bills Purchased and Discounted: The auditor should familiarise himself with the guidelines issued by the RBI and the policies framed by the bank itself regarding the discounting and rediscounting of bills. The auditor should ascertain that the policy framed by the bank conforms to the requirements laid down by the RBI.

Bills purchased and discounted have to be shown separately in the balance sheet as a part of

¹ Reference may be made in this regard to Standards on Auditing (SA) 620, "Using the Work of an Expert".

11.38 Advanced Auditing and Professional Ethics

'advances'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.

Banks purchase or discount bills of exchange drawn or endorsed by their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.

In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a contingent liability.

Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:

- (a) all the outstanding bills have been taken in the balance sheet;
- (b) all the details, including the nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified;
- (c) the bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit; and
- (d) the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for the delay and the action taken by the bank.

The auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether the bills and the documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the bills, it should be ensured that the bills are held along with the documents of title. In the case of documentary bills, it should be ensured that the related RRs/TRs are held along with the invoices/ hundies / bills and that these have not been parted with. Wherever such RRs/TRs are not held on record, the fact should be duly considered by the auditor. The auditor should also examine bills collected subsequent to the year-end to obtain assurance regarding completeness and validity of the recorded bill amounts.

Other Aspects: Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at a number of other branches also, for each of which a sub-limit is fixed. In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power, and not by each of the other branches where a sub-limit has been fixed. The auditor should examine that any advances made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, advance for

purchase of assets, etc., is not included under the head 'advances' but is included under 'other assets'.

The amounts of advances in India and those outside India are to be shown separately in the balance sheet. The auditor should examine whether any loan has been granted in violation of the statutory limitations contained in section 20 of the Banking Regulations Act, 1949. If any such loan has been granted the report will have to be drafted with suitable qualifications, as the transaction would be *ultra vires*.

It may also be examined whether the bank has a system of ensuring the end use of the funds granted as compared with the purpose of sanction. The reports submitted by the inspectors/officers in this regard should be reviewed to form opinion on the quality of the asset and also to consider reporting any matter in the LFAR.

Adverse features in a borrower's account are required to be reported in LFAR and hence during the course of verification all material information should be noted and documented in appropriate format. Following is an illustrative but not an exhaustive format:

1. Name of the Borrower.
2. Constitution.
3. Sanctioned limits as on Balance Sheet date.
4. Any change in limit during the year.
5. Terms of sanction.
6. Details of fulfilment of terms of sanction.
7. Details of Loan documents and observations on the same.
8. Balance outstanding as at balance sheet date.
9. Classification as per bank.
10. Whether classification requires a change.
11. If so the reasons for the differing view and the impact of the same.
12. Whether necessary changes made in Memorandum of Changes.
13. Observations on the conduct of the account.
14. Deficiencies noted in the account.
15. Availability of security.
16. Timely submission of stock statement and other statements.

Verification of Provision for Non-performing assets: An important aspect of audit of advances relates to their classification and provisioning. This implies that a proper provision should be made in respect of advances where the recovery is doubtful. As mentioned earlier, the Reserve Bank has prescribed objective norms for determining the quantum of provisions required in respect of advances. The auditors must take / download the latest Master Circular of RBI to familiarise himself fully with the norms prescribed by RBI in this regard. The circulars

11.40 Advanced Auditing and Professional Ethics

issued by RBI after the date of issue of Master Circular and till the date of audit should also be taken / downloaded and reviewed by the auditors for its adherence. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made. In this regard, the provisions of section 15 of the Banking Regulation Act, 1949 may be noted. This section, which applies to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks, requires the bank concerned to make adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

The accounting entry for provision in respect of debts that are doubtful of recovery is usually made at the head office level and is not recorded in the books at the branch level. The amount of provision to be made at the head office level is based largely on the classification of various advances into standard, sub-standard, doubtful and loss categories. The auditor should carefully examine whether the classification made by the branch is appropriate. In doing so, he should particularly examine the classification of advances where there are threats to recovery. The auditor should also examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.

As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is of significant importance to determine the classification and hence specific care be taken in this regard.

Drawing Power Calculation: Working capital borrowal account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" account continues for 90 days, account has to be classified as NPA, even though the account is otherwise operated regularly.

The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.

The audited Annual Report submitted by the borrower should be scrutinised properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

The stock audit should be carried out by the bank for all accounts having funded exposure of more than ₹ 5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power.

Limits not reviewed: Accounts where regular/*ad hoc* limits are not reviewed within 180 days from the due date/date of *ad hoc* sanction, have to be considered as NPA. Auditors should also ensure that the *ad hoc*/short reviews are not done on repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.

Government Guaranteed Advances: If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realised. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. This exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

Agricultural Advances: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops, would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him. The above norms should be made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector. In respect of agricultural loans, other than those specified in the circular, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

11.42 Advanced Auditing and Professional Ethics

Provisioning Towards Standard Assets: The auditor should check the latest RBI Circulars in this regard. The provisions need to be checked in detail with the statement of advances. The provisions bifurcation of standard advances under relevant category for proper calculation of provision should be checked and certified at branches level. The definition of respective items specified should be adhered as defined by RBI.

Restructuring of cases: RBI has given revised the guidelines for treatment of restructured accounts by its circular. The auditor should verify compliance with the requirements of the circular issued in this regard. Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Thereby during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts pending approval for restructuring.

Upgradation of Account: The auditor should examine all the accounts upgraded during the year to ensure that the upgrading of each account is strictly in terms of RBI guidelines.

Auditor has to ensure that any upgrading of accounts classified as 'Sub-Standard' or 'Doubtful' category wherein restructuring / rephasing of principal or interest has taken place should be upgraded to the 'Standard Asset' category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this period of one year should be recovered and there should be no overdues to make it eligible for upgradation. If the amount which has become due during this one year period is on a lower side vis a vis total amount outstanding, the other aspects of the account, viz financial performance, availability of security, operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.

Audit Procedure for Accounts falling under CDR (Corporate Debt Restructuring) Programme: Following audit procedures are to be carried out to assess / gain an understanding about the borrower account-

- (a) Review the present classification of the account under IRAC norms adopted by the bank and corresponding provision made in the books of accounts, if any. If the account is already treated as NPA in the books of the bank, the same cannot be upgraded only because of the CDR package.
- (b) Review the Debtor- Creditor Agreement (DCA) and Inter Creditor Agreement (ICA) with respect to availability of such agreements and necessary provisions in the agreement for reference to CDR cell in case of necessity, penal clauses, stand-still clause, to abide by the various elements of CDR system etc., (DCA may be entered into at the time of original sanction of loan or at the time of reference to CDR).
- (c) Auditor has to ascertain the terms of rehabilitation along with the sacrifices, if any, assumed in the rehabilitation program to verify whether such sacrifices have been accounted in the books of accounts of the lender. Ascertain whether any additional financing / conversion of loan into equity have been envisaged in the rehabilitation / restructuring program.

Auditor should also ascertain whether account has been referred to BIFR, as such cases are not eligible for restructuring under CDR system. Large value BIFR cases may be eligible for restructuring under CDR if specifically recommended by CDR core group. Auditor has to verify the necessary approvals / recommendations by CDR core group if auditor comes across any BIFR cases.

Auditor has to ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by at least by 75% of the creditors by value and 60% in number provided the account meets the basic criteria for becoming eligible under CDR mechanism.

Treatment of accounts restructured under CDR program: Classification and Provisioning: The criteria for classification of accounts will be on the basis of record of recovery as per the existing prudential norms. The asset classification will be as per the lender bank's record of recovery and will be bank specific.

The auditor should ensure that the lender has applied the usual asset classification norms pending outcome of the account with the CDR Cell. The asset classification status should be restored to the position, which existed at the time of reference to the cell if the restructuring under the CDR system takes place.

The auditor should also ensure that in case a standard asset has been restructured second or more time, it has been downgraded to "sub-standard" asset.

The auditor should also ensure that proper disclosure in the Notes to Accounts in respect of CDR of SME undertaken by the bank during the year, as prescribed in the RBI's circular, has been made.

Sale/ Purchase of NPAs: In case of a sale/ purchase of NPAs by the bank, the auditor should examine the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

The auditor should also examine that:

- (i) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- (ii) the assets have been sold/ purchased "without recourse" only.
- (iii) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.
- (iv) the NPA has been sold at cash basis only.
- (v) the bank has not purchased an NPA which it had originally sold.

In case of sale of an NPA, the auditor should also ensure that:

- (i) on the sale of the NPA, the same has been removed from the books of the account.
- (ii) the short fall in the net book value has been charged to the profit and loss account.

11.44 Advanced Auditing and Professional Ethics

- (iii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss on account of sale of other non-performing financial assets.

Similarly, in case of purchase of NPAs, the auditor should verify that:

- (i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.
- (ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
- (iii) for the purpose of capital adequacy, banks has assigned 100% risk weights to the NPAs purchased from other banks.

IV. Fixed Assets - The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, viz., Premises and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs).

Audit Procedures: In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their existence and valuation. For this purpose, the auditor should review the system of internal controls relating to fixed assets, particularly the following:

- ◆ Control over expenditures incurred on fixed assets acquired or self constructed;
- ◆ Accountability and utilisation controls; and
- ◆ Information controls for ensuring availability of reliable information about fixed assets.

The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, he should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., relating to fixed assets are maintained at the branch. Where the acquisition, disposal, etc., of fixed assets take place at branches / other offices, but accounting of fixed assets is done at the head office, the branch auditor should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.

Premises: The auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorisation and documents such as, contractors' bills, work order records and record of payments. The auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the

ledger and the final statements.

In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance residual life.

In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the central statutory auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item under the head 'fixed assets' or under the head 'other assets'. It should be ensured that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as "premises under construction". In such cases even if all the bills/ documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

Where the premises (or any other fixed assets) are re-valued, the auditor should examine the appropriateness of the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with relevant Accounting Standard ". The auditor should also check the impairment, if any, by applying the principles laid down in relevant Accounting Standard .

The auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, howsoever acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use. The auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.

Other Fixed Assets: The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of moveable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/internal/concurrent audit team. He should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made.

In recent years, banks have incurred substantial expenditure on computer hardware and software. Computer software that is essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. The expenditure incurred on acquisition and installation of the hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalised in accordance

11.46 Advanced Auditing and Professional Ethics

with the principles laid down in relevant Accounting Standard and depreciated over the remaining useful life of the hardware. Hardware and software are susceptible to faster rate of technical obsolescence, hence the auditor must take into consideration this fact while verifying the provision for depreciation on these assets. The same, however, should not be depreciated for a period of more than three years.

Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". The treatment of expenditure on applications software, whether acquired from outside or developed in-house, would also be similar. However, in estimating the useful life of applications software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS 26, "Intangible Assets", according to which expenditure incurred during the research phase should not be capitalised as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to Paragraph 44 of the said Standard. While conducting the audit of intangible assets, the auditor should also consider the guidelines given by RBI by way of Circulars.

Many a time, fixed assets like furniture, office equipments, etc. are transferred from one branch to another. The auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers.

It should be examined whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For example, items like safe deposit vaults should not be clubbed together with the office equipments or the theft alarm system of the bank.

In respect of fixed assets sold during the year, a copy of the sale deed, if any, and receipt of the sale value should be examined by the auditor. In such a case, it should also be seen that the original cost and accumulated depreciation on the assets sold have been correctly adjusted. Profit earned or loss incurred on such sales should also be checked.

The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly.

The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers ins/outs, are tallied. A broad check on the depreciation amount *vis-a-vis* the gross block of assets be reviewed with special emphasis on the computer hardware/software.

Leased Assets: RBI's Circular No. DBOD No.FSC.BC.70/24.01.001/99 dated July 17, 1999 deals with accounting and provisioning norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases".

Impairment of Assets: AS 28 prescribe the procedures that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount. An asset is treated as carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognise an impairment loss. This Standard also prescribes when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets. This Standard requires that an enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss if recognised shall be debited in the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exists, the loss should first be debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same should be debited to profit and loss account. RBI's circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- ◆ The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- ◆ Banks may also take into account the following specific factors while complying with the Standard:
 - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.
 - In addition to the assets of banks which are specifically identified above, viz., financial assets, inventories, investment, loans and advances etc to which the Standard does not apply, the Standard would apply to financial lease assets and non banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

V. Other Assets - The branch auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner:

Inter-Office Adjustments: Inter-branch accounts are normally reconciled by each bank at the central level. While practices with various banks may differ, the inter-branch accounts are normally sub-divided into segments or specific areas, e.g., 'Drafts paid/ payable', 'inter-branch remittances', 'H.O. A/c', etc. The auditor should report on the year-end status of inter-branch accounts indicating the dates up to which all or any segments of the accounts have been reconciled. The auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries. The auditor can obtain the relevant information primarily from branch audit reports.

Interest Accrued: The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks

11.48 Advanced Auditing and Professional Ethics

normally debit the borrower's account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances as banks normally debit the borrowers account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances. On the other hand interest on government securities, debentures, bonds, etc. which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. ***The auditor should examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/discounted.***

The auditor should ensure that only such interest as can be realised in the ordinary course of business should be shown under this head. This is based on the principle, recognised in AS 9, that revenue cannot be recognised if there is a significant uncertainty about its collectability. Dividends recognised as income but not received may be included in the residuary sub-head of 'others'. Dividends and interest on investments would be recognised in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

Tax Paid in Advance/Tax Deducted at Source: Generally, this item is dealt with at the head office level only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services is handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to ensure that the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

At Head Office level, the availability of all the TDS Certificates, submission of the same with Income Tax Department/claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.

Stationery and Stamps: Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller's cheques, gift cheques, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to a misappropriation of the most valuable physical asset of a bank, viz., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in his LFAR.

The item "Stationery and Stamps" should include only exceptional items of expenditure on stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose

the bank to a potential loss from misuse. The auditor should examine whether the cost of stationery and stamps consumed during the year has been properly charged to the profit and loss account for the year in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

Non-Banking Assets Acquired in Satisfaction of Claims: Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

While examining this item, the auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however, acquired (i.e. whether acquired by way of satisfaction of claims or otherwise), except such as is required for its own use, for any period exceeding seven years from the date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years. (It may be noted that the aforesaid section is applicable to banking companies only and not to other types of banks like nationalised banks.)

The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. He should satisfy himself that the ownership of the property has legally vested in the bank. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

Others: This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below-

Non-Interest Bearing Staff Advances: The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the policy in this regard which is framed by the bank. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be ensured that the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

Security Deposits: Security deposits with various authorities (e.g., on account of telephone, electricity, etc.) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. It needs to be ensured that the deposit amount has not become due as per the terms and conditions. If it is so, then the recoverability of the same

11.50 Advanced Auditing and Professional Ethics

needs to be looked into in detail and appropriate provision be made against the amount which is doubtful to recover.

Suspense Account: 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, the suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

- (i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;
- (ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;
- (iii) amounts of losses on account of frauds awaiting adjustment.

The auditor should pay special attention to any unusual items in suspense account. He should obtain from the management details of old outstanding entries in suspense account along with reasons for delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/write-off.

Prepaid Expenses: The auditor should verify prepaid expenses in the same manner as in the case of other entities. Thus, the auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. He should particularly examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.

Miscellaneous Debit Balances on Government Account: Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. The auditor should review the ageing statements pertaining to these items. He should particularly examine the recoverability of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts.

The residual item of "Others" in Other Assets generally constitutes a significant amount in the Balance Sheet of the bank. The Head Office auditors should obtain the head wise details of the same along with the previous year figures. The age-wise details of the major outstanding should also be obtained, wherever, feasible. Further, the major variance as compared to the previous year figures should also be enquired into and reasons for the same should be recorded and reviewed. In case any amount seems doubtful of recovery, appropriate provisions against the same should be made.

VI. Capital - The following particulars have to be given in respect of share capital in the balance sheet.

(a) For Banks Incorporated in India

Authorised Capital	(shares of ₹ each)
Issued Capital	(-do-)
Subscribed Capital	(-do-)
Called-up Capital	(-do-)

Less: Calls unpaid

Add: Forfeited shares

(In case of Nationalised Banks capital owned by Central Government as on the date of balance sheet including contribution from Government, if any, for participating in World Bank Projects should be shown separately.)

(b) For Banks Incorporated Outside India

- (i) Capital (the amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head).
- (ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949.

The auditor should verify the opening balance of capital with reference to the audited balance sheet of the previous year. In case there has been an increase in capital during the year, the auditor should examine the relevant documents supporting the increase. For example, in case of an increase in the authorised capital of a banking company, the auditor should examine the special resolution of shareholders and the memorandum of association. An increase in subscribed and paid-up capital of a banking company, on the other hand, should be verified with reference to prospectus/other offer document, reports received from registrars to the issue, bank statement, etc.

11.7 Capital Adequacy

The term 'capital adequacy' is used to describe the adequacy of capital resources of a bank in relation to the risks associated with its operations.

Adequacy of capital of banks has been the subject matter of consideration by banking authorities around the world for several decades. For example, in 1975, the Bank of England published the conclusions of a Joint Working Party which had been formed by the Bank along with several clearing banks to examine the nature of capital and of liquidity of banks and to develop principles for examining their adequacy. The paper outlined two ratios for assessing the adequacy of capital: 'free resources ratio' and 'risk asset ratio'. The *free resources ratio* related current liabilities to capital resources excluding the part of capital devoted to financing infrastructure and other non-banking assets. The *risk asset ratio* related the risk of losses inherent in the assets of the business of banks to the capital available to absorb such losses. The paper argued that the risk asset ratio was more useful.

11.52 Advanced Auditing and Professional Ethics

The risk asset measure has since received wide international acceptance as the basis for measuring the capital adequacy of banks. An international agreement on a common risk-based capital framework and definition of bank capital was framed by the Committee on Banking Regulations and Supervisory Practices of the G-10 Nations (popularly known as the Basel Committee) and was formally adopted in 1988. It was also adopted by all the twenty-five countries that were either full members of the Organisation for Economic Co-operation and Development or had special lending arrangements under the International Monetary Fund's general borrowing procedures.

The framework attempted to relate a bank's capital needs to its risk profile. Besides serving to strengthen the soundness and stability of the banking system, it also sought to give banks an incentive to hold lower-risk assets, incorporate off-balance sheet exposures explicitly into capital assessments, and achieve greater uniformity in application of capital standards to banks across different countries. The prescribed minimum capital standards for risk-based capital were to apply to banks on a transitional basis beginning at the year-end 1990 and were to be fully in place by end 1992.

Capital Adequacy Measures in India: In India, the statutes governing various types of banks lay down the minimum capital requirements for them. Besides, there are also requirements for maintenance of statutory reserves. Considering the variations in minimum capital requirements applicable to different types of banks and taking into account the approach adopted by Basel Committee, the Reserve Bank prescribed, in year 1992, a uniform methodology for determining the capital adequacy of scheduled commercial banks (other than regional rural banks). The Master Circular on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)", provides the guidelines to be followed by banks for capital adequacy. Some of the important aspects of the circular are covered below.

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments' quality as capital.

- ◆ **Tier I capital** consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.
- ◆ **Tier II capital** consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

Components of Capital: The Master Circular on Capital Adequacy discusses the Capital Funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India. The following table shows the components of the Capital Funds for Indian *vis a vis* foreign banks operating in India.

	Indian Banks	Foreign Banks operating in India
Tier Capital I	Paid up capital (ordinary shares)	Interest free funds from Head Office ²
	Statutory reserves	Statutory reserves kept in Indian books
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Innovative perpetual debt instruments eligible for inclusion as Tier I capital	Innovative Instruments eligible for inclusion as Tier I capital
	Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital subject to laws in force from time to time*	Capital reserves representing surplus arising out of sale proceeds of assets
		Interest free funds remitted from abroad for the purpose of acquisition of property
Tier Capital II		Head office borrowings in foreign currency by foreign banks operating in India
	Revaluation reserves	Revaluation reserves
	General provisions and loss reserves	General provisions and loss reserves
	Hybrid debt capital instruments, which includes Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares(RCPS) and Debt capital instruments	Hybrid debt capital instruments which includes Perpetual Cumulative Preference Shares (PCPS)/Redeemable Non-Cumulative Preference Shares(RNCPS) /Redeemable cumulative preference shares(RCPS) and Debt capital instruments
	Subordinate debts	Subordinate debts
	Innovative Perpetual Debt Instruments (IPDI) and Perpetual Non- Cumulative Preference Shares (PNCPS)	

² Kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.
 * The annexure to the Master Circular on Prudential Norms on Capital Adequacy-Basel I Framework provides the guidelines for Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital.

11.54 Advanced Auditing and Professional Ethics

In case of foreign banks operating in India, RBI's Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

Undisclosed Reserves: They can be included in capital, if they represent accumulations of post-tax profits and are not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses.

Re-valuation Reserves: It would be prudent to consider re-valuation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as re-valuation reserves.

General Provisions and Loss Reserves: Such reserves can be included in Tier II capital if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets. 'Floating Provisions' held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets, if such provisions are not netted off from gross NPAs to arrive at disclosure of net NPAs

Hybrid Debt Capital Instruments: Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital. At present following instruments have been recognised and placed under this category.

- i. Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS)/Redeemable Cumulative Preference shares (RCPS) as part of upper Tier II capital.
- ii. Debt capital instruments eligible for inclusion as Upper Tier II capital.

Subordinated Debt: To be eligible for inclusion in Tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the RBI. They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount, for inclusion in Tier II capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier II capital.

Investment Reserve Account: In the event of provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 –“Reserves & Surplus” under the head “Revenue and other Reserves” and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

Banks are allowed to include the 'General Provisions on Standard Assets' and 'Provisions held for Country Exposures' in Tier II capital. However, the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

Capital Risk Adequacy Ratio (CRAR)

The CRAR is computed as follows:

$$\frac{\text{Capital Funds}}{\text{Risk weighted assets and off-balance sheet items}} \times 100$$

The RBI requires banks to maintain a minimum CRAR of 9 per cent on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items and CRAR.

VII. Reserves and Surplus - The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.

- I. Statutory Reserves
- II. Capital Reserves
- III. Share Premium
- IV. Revenue and Other Reserves including investment Fluctuation Reserve

(In respect of items I – IV above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item)

- V. Balance in Profit and Loss Account

Statutory Reserves: Under sub-section (1) of section 17 of the Banking Regulation Act, 1949 every banking company incorporated in India has to transfer 20% of its profits to its reserve fund each year before declaring dividends. The transfer to reserve as above and any other reserve created in pursuance of any section of the Act has also to be disclosed under the aforesaid head. Sec 17(2) of Act provides that where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the RBI, explaining the circumstances relating to such appropriation.

All scheduled commercial banks, including foreign banks operating in India, (except RRBs/LABs) have been instructed to transfer not less than 25% of the 'net profit' (before appropriations) to the Reserve Fund with effect from the year ending 31st March, 2001. Such transfer to reserves may be made "after adjustment / provision towards bonus to staff".

Capital Reserves: The expression 'capital reserves' does not include any amount regarded as free for distribution through the profit and loss account. According to the Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, surplus on re-valuation or sale of fixed assets is to be treated as capital reserve.

Securities Premium Account: According to section 52 of the Companies Act, 2013, where a company issues shares at a premium, the amount of premium should be transferred to a

11.56 Advanced Auditing and Professional Ethics

separate account to be called the 'securities premium account'. The provisions of the Companies Act, 2013 regarding reduction of capital also apply to securities premium account. However, as per section 52, the securities premium may be applied for the following purposes:

- (a) issuing fully paid bonus securities;
- (b) writing off the preliminary expenses;
- (c) writing off the expenses of, or the commission paid or discount allowed on, any issue of securities or debentures;
- (d) providing for the premium payable on the redemption of any redeemable preference securities or debentures; or
- (e) for the purchase of its own shares or of other securities under section 68 of the Companies Act, 2013.

A banking company has to report to the RBI any appropriations made from the securities premium account. Such an appropriation can be only for the purposes described above or in accordance with the provisions governing reduction of share capital by a company.

Revenue and Other Reserves: According to the Notes and Instructions for Compilation of Balance Sheet and Profit and Loss Account, issued by the RBI, the expression 'Revenue Reserve' shall mean any reserve other than capital reserve.

All reserves, other than those separately classified (viz., statutory reserves, capital reserves and share premium) will be shown under this head. The expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. In terms of RBI guidelines, the 'Investment Reserve Account' representing write back of excess provision on investments has to be treated as revenue reserve.

Balance of Profit: This item includes balance of profit after appropriations. According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, in case of loss, the balance may be shown as a deduction. Though it is not mentioned whether the loss is to be deducted from the aggregate of 'reserves' or from 'revenue and other reserves' only, it is obvious on a consideration of legal requirements and sound accounting principles that the loss should be deducted only from revenue reserves.

Further, as prescribed by RBI's circular, the banks need to obtain prior approval of the Reserve Bank of India before any appropriation is made from the statutory reserve or any other reserve.

The said circular also requires that:

- (i) all expenses including provisions and write offs recognised in a period, whether mandatory or prudential, should be reflected in the Profit and Loss Account for the period as an 'above the line' item (i.e., before arriving at the net profit);
- (ii) wherever draw down from reserves takes place with the prior approval of Reserve Bank, it should be effected only "below the line", (i.e., after arriving at the profit/loss for the period); and

- (iii) suitable disclosures should be made of such draw down of reserves in the 'Notes on Accounts' to the Balance Sheet.

Audit Procedures: The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and share premium, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with. In case the bank has been granted exemption from such transfer, the auditor should examine the relevant documents granting such exemption. Similarly, it should be examined whether the appropriations from share premium account conform to the relevant legal requirements.

VIII. Deposits - Deposits are required to be classified in the balance sheet under the following heads.

- A. I. *Demand Deposits*
 - (i) From Banks
 - (ii) From Others
- II. *Savings Bank Deposits*
- III. *Term Deposits*
 - (i) From Banks
 - (ii) From Others
- B. I. *Deposits of branches in India*
- II. *Deposits of branches outside India*

Audit Procedures: In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

The auditor may verify various types of deposits in the following manner:

Current Accounts: The auditor should verify the balances in individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

Some banks have a procedure for obtaining confirmation of balances periodically. The auditor should examine whether the procedure laid down in this behalf has been followed consistently throughout the year. He should also examine, on a sampling basis, the confirmations received.

The auditor should ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'advances'.

Inoperative accounts are a common area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts

11.58 Advanced Auditing and Professional Ethics

revived during the year. The auditor should also ascertain whether inoperative accounts are 'revived' only with proper authority. For this purpose, the auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorisation for withdrawals.

Savings Bank Deposits: The auditor should verify the balances in individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

The auditor should also check the calculations of interest on a test check basis. In case of branch under Core Banking Solution (CBS) the product sheet for calculation of interest on saving bank account can be obtained in selected sample and can verify the calculation. In case of manual branches the calculation can be verified as per the work sheets.

As in the case of current accounts, the auditor should pay special attention to inoperative savings bank accounts.

Term Deposits: While evaluating the internal controls over term deposits, the auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. The auditor should also satisfy himself that there is a proper control over the unused forms of deposit receipts and cash certificates to prevent their misuse.

As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the depositor. This area is quite sensitive. The auditor should bear this fact in mind while examining the efficacy of prescribed internal controls with regard to rates of interest on CDs.

The auditor should verify the deposits with reference to the relevant registers. The auditor should also examine, on a sampling basis, the registers with the counter-foils of the receipts issued and with the discharged receipts returned to the bank. The reconciliation of subsidiary records for various types of term deposits with the related control accounts in the General Ledger should be examined. The auditor should also examine whether provision has been made for interest accrued on the deposits up to the date of the balance sheet. Auditor should ensure that proper provision for interest payable on deposits is made.

In some cases, banks employ some persons as 'collectors' to collect the deposits from depositors, e.g., in case of recurring deposits. In such cases, the auditor should specifically examine the efficacy of the internal control procedures for reconciling the records of the bank with those of the collectors.

Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

Deposits Designated in Foreign Currencies: In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year. Further, in case of conversion of FCNR (B) deposits

into NRE deposits or *vice versa* before maturity has been subjected to the provisions relating to premature withdrawal.

Interest Accrued But Not Due: The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head 'other liabilities and provisions'.

Overall Reconciliation: The procedures of banks usually provide for periodic correlation of outstanding deposits with the cost of deposits. The auditor should ascertain from the management whether such an exercise has been carried out and if so, he should review the same. The auditor should examine that interest accrued but not due has also been considered for this purpose.

Window-dressing: There are several ways in which the deposits of a bank may be inflated for purposes of balance sheet presentation. For example, some of the constituents may be allowed overdraft on or around the date of the balance sheet, the overdrawn amounts may be placed as deposits with the bank, and further advances may be given on the security of the deposit receipts, thus inflating deposits as well as advances. The transactions may be reversed immediately after the close of the year. Where the auditor comes across transactions, which indicate the possibility of window-dressing, he may report the same in his long form audit report. In appropriate cases, the auditor should consider making a suitable qualification in his main audit report also.

Know Your Customers Norms: RBI has issued instructions to all banks to implement without fail certain procedural norms on KYC. Failure would attract levy of penalty and if penalty has been levied the same is to be disclosed in the notes to accounts. In view of the nature of the directive the audit procedure may be suitably adopted to enquire the system of implementation and review of other reports in respect of this area. The auditor should examine that an adequate there exists proper procedure in place to ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

IX. Borrowing - Borrowings of a bank are required to be shown in balance sheet as follows.

I. Borrowings in India

- (i) Reserve Bank of India
- (ii) Other Banks
- (iii) Other Institutions and Agencies

II. Borrowings outside India

The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule. Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and therefore, should not be presented as such.

Audit Procedures

Borrowings from RBI, other banks/financial institutions, etc. should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, agreements, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of SA 505 "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

The auditor should also examine whether a clear distinction has been made between 'rediscount' and 'refinance' for disclosure of the amount under the above head since rediscount does not figure under this head.

The auditor should examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor.

The auditor should similarly examine the relevant correspondence or other documents to ensure that the branch has been authorised by the head office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation.

The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

X. Other Liabilities and Provisions - The Third Schedule to the Banking Regulation Act, 1949, requires disclosure of the following items under the head 'Other Liabilities and Provisions'.

- (a) Bills payable
- (b) Inter-office adjustments (net)
- (c) Interest accrued
- (d) Others (including provisions)

Audit Procedures: The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

Bills Payable: The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following -

- (a) Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms.
- (b) Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.
- (c) The bank should have a reliable private code known only to the responsible officers of its branches coding and decoding of the telegrams should be done only by such officers.
- (d) The signatures on a demand draft should be checked by an officer with the specimen

signature book.

- (e) All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.
- (f) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.
- (g) In case an instrument prepared on a security paper, e.g., draft, has to be cancelled (say, due to error in preparation), it should be ensured that the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which drafts issued are entered.) Cases of frequent cancellation and re-issuance of drafts, pay orders, etc. should be carefully looked into by a responsible official.

Based on his evaluation of the efficacy of the relevant internal controls, the auditor should examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained. Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice) should also be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

Others (Including Provisions): It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

Inter-office Adjustments - The balance in inter-office adjustments account, if in credit, is to be shown under this head.

Interest Accrued - Interest accrued but not due on deposits and borrowings is to be shown under this head. The auditor should examine this item with reference to terms of the various types of deposits and borrowings. It should be specifically examined that such interest has not been clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.

Others (including provisions) - According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, the following items are to be included under this head:

- (a) Net provision for income tax and other taxes like interest tax, less advance payment and tax deducted at source.
- (b) Surplus/provisions in bad and doubtful debts provision account (such surplus is in the nature of a reserve).
- (c) Surplus/provisions for depreciation in securities (such surplus is in the nature of a

11.62 Advanced Auditing and Professional Ethics

reserve).

- (d) Contingency funds, which are actually in the nature of reserves but are not disclosed as such.
- (e) Proposed dividend/transfer to Government.
- (f) Other liabilities, which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc.
- (g) Certain types of deposits like staff security deposits, margin deposits, etc., which are repayable only subject to compliance with certain conditions. (The interest on such deposits would also be included under this head).
- (h) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

Besides the above items, the following are other important items usually included under this head:

- (a) Collections in respect of suit-filed accounts. These are not adjusted against advances till final settlement. (However, for the purpose of provisioning against non-performing advances, such credit balances are taken into account for ascertaining net outstandings).
- (b) Collection of income-tax on behalf of the Government.
- (c) Collection from DICGC. These are carried till final realisation/write-off of the concerned advance account.
- (d) Provisions for frauds. These are ultimately adjusted by way of a write-off.
- (e) Insurance claims received in respect of frauds. These are retained separately till final write-off in respect of fraud.
- (f) Provision for gratuity, pension and other staff benefits.
- (g) Provision for bank's share in the expenses of the Banking Services Recruitment Board.
- (h) Provision for audit fees.
- (i) ***Unamortized interest income on the bills purchased/ discounted.***

It may be noted that many of the items to be disclosed under this head are accounted for at the head office level and would not therefore form part of balance sheet of a branch.

XI. Contingent Liabilities - The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

- (a) Contingent Liabilities
 - I. Claims against the bank not acknowledged as debts
 - II. Liability for partly paid investments
 - III. Liability on account of outstanding forward exchange contracts.

- IV. Guarantees given on behalf of constituents
 - (a) In India
 - (b) Outside India
- V. Acceptances, endorsements and other obligations
- VI. Other items for which the bank is contingently liable
 - (b) Bills for Collection

Audit Procedures

Contingent Liabilities: In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

- (a) the auditor should ensure that there exists a system whereby the non fund based facilities or additional/*ad hoc* credit facilities to parties are extended only to their regular constituents, etc.
- (b) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
- (c) The auditor should also ensure that in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
- (d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.
- (e) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
- (f) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
- (g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.
- (h) Obtain representation from the management that:
 - (i) all contingent liabilities have been disclosed;
 - (ii) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;

11.64 Advanced Auditing and Professional Ethics

- (iii) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including any possibility of any reimbursement;
 - (iv) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulations Act, 1949 has arisen on account of such guarantee; and
 - (v) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote, include the management's justification for reaching such a decision in respect of those contingent liabilities.
- (i) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit)*. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.
 - (j) Verify whether bank has extended any non-fund facility or additional/*ad hoc* credit facilities to other than its regular customers. In such cases, auditor should ensure concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

Claims Against the Bank Not Acknowledged as Debts: The auditor should examine the relevant evidence, e.g., correspondence with lawyers/others, claimants, workers/officers, and workmen's/officers' unions. The auditor should also review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc. to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of the year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Liability on Account of Outstanding Forward Exchange Contracts: The auditor may verify the outstanding forward exchange contracts with the register maintained by the branch and with the broker's advice notes. In particular, the net "position" of the branch in relation to each foreign currency should be examined to see that the position is generally squared and not uncovered by a substantial amount. The net "position" as reported in the financial statements may be verified with reference to the foreign exchange position report prepared by the back office.

* In terms of the Circular No. A.P. (Dir. Series) 60 dated January 31, 2004, any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

Guarantees Given on Behalf of Constituents: The auditor should ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customers before issuance of guarantees as per the prescribed procedures, etc.

The auditor should ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms are periodically verified and reconciled with the book records, etc.

The auditor should examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

The auditor should check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. The auditor should also examine that expired guarantees are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued upto the year-end which are yet to be recorded.

Acceptances, Endorsements and Other Obligations: The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees.

The auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified.

Other Acceptances and Endorsements: The auditor should study the arrangements made by the bank with its customers. He should test check the amounts of the bills with the register maintained by the bank for such bills. The auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

In respect of letters of comfort, the auditor should examine whether the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no contingent liability need to be disclosed on this account.

Common Procedures: The auditor should obtain a written confirmation from the management that all obligations assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed upto the year-end, which are yet to be recorded.

11.66 Advanced Auditing and Professional Ethics

The auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc. has resulted in an actual obligation owing to any act or default on the part of its constituent. In such a case, a provision would have to be made in the accounts for the bank's obligation. The amount of the provision should be determined taking into account the probable recovery from the customer.

Other Items for which the Bank is Contingently Liable: The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

In respect of disputed tax demands, the auditor should examine whether there is a positive evidence or action on the part of the bank to show that it has not accepted the demand for payment of tax or duty. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of AS 29, "Provisions, Contingent Liabilities and Contingent Assets". In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level. However, the principles enunciated above should be followed in dealing with taxes and duties (such as, local taxes) dealt with at the branch level.

The auditor should also look into the manner of disclosure of interest rate swaps in the financial statements of the bank. The interest rate swaps would be treated as real or contingent liability depending upon the facts and circumstances of each case in accordance with the provisions of the Accounting Standard (AS) 29.

The auditor as in the case of other entities may verify other items under this head.

Bills for Collection: The auditor should ensure that the bills drawn on other branches of the bank are not included in bills for collection.

Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.

The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

In regard to bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

Co-acceptance of Bills: The auditor should ensure that the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI's Master Circular on Guarantees and Co-acceptances.

Liability on Partly Paid Investments - If the bank holds any partly paid shares, debentures, etc., the auditor should examine whether the uncalled amounts thereof are shown as contingent liability in the balance sheet.

Liability on Account of Outstanding Forward Exchange Contracts - All branches which undertake foreign exchange business (i.e., those which are authorised foreign exchange dealers) usually enter into forward exchange contracts. The amount of forward exchange contracts, which are outstanding on the balance sheet date, is to be shown under this head.

11.8 Concurrent Audit

Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place. It is akin to internal audit which is a concept recognised under the Companies Act. In view of the complexities of economic activities it is now well recognised that there must be a system of someone, other than the person involved in the operations, verifying the authenticity of the transaction/activity on a regular basis so that any deviation from the laid down procedures can be noticed in the shortest possible time and remedial action can be taken.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. In some banks this task has been entrusted to the internal inspection staff who are not engaged in operational activities. In other banks, this work is allotted to outside professional firms of chartered accountants. The Reserve Bank of India (RBI) has issued certain guidelines for the conduct of this audit.

These guidelines are mandatory and all banks are required to cover 50 percent of total deposits and 50 per cent of total advances under this audit. This will mean that all banks will have to put their large branches under this audit.

11.68 Advanced Auditing and Professional Ethics

11.8.1 Scope of Concurrent Audit - The guidelines issued by the RBI cover all the important areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:

- (i) Daily cash transactions with particular reference to any abnormal receipts and payments. This will include currency chest transactions, major expenses incurred by cash payments and high value cash receipts and disbursements.
- (ii) Purchase and sale of shares, securities, etc. physical verification of investments and verification of rates at which transactions are entered into. Similarly, examination of capital expenditure on purchase of capital assets as well as sales of such assets. This will include verification of relevant documents and authorisation.
- (iii) Verification of procedure and documentation for opening new current, savings, term deposit accounts, etc. If there are any unusual operations in these new accounts the same should be examined thoroughly and unusual-features should be reported.
- (iv) Verification of Advances-Overdrafts, TOD, CC Accounts, Term Loans, Bills Purchase, L.C., Guarantees, Overdues, devolvement, and L.C./Guarantee, etc. For this verification special attention is required to be given to (a) procedure for sanction and renewal of limits and proper authorisation (b) disbursement of funds within limits and according to terms of sanction (c) recovery of funds (d) verification of godown, stock, securities, etc. (e) documentation including renewal of documents, registration of charges, mortgages, etc. (f) classification of advances (g) study of financial health of customers by observation about conduct of accounts, regular compliance by submission of financial information, stock statements, etc. and study of audited annual accounts of corporate as well as non-corporate customers, (h) timely signals for accounts likely to become doubtful (i) timely legal action for recovery (j) verification of interest and other service charges levied as per terms of sanction (k) credit rating of borrower and (l) compliance with special conditions contained in the terms of sanction.
- (v) Foreign Exchange transactions – if the branch is authorised to handle foreign exchange transactions these transactions have to be verified in detail in accordance with RBI guidelines. All aspects of Import/Export transactions, Foreign Bills transactions, Foreign L.C./Guarantees, FCNR/NRI deposits, Nostro/Vostro accounts, compliance with RBI guidelines and reporting will have to be examined.
- (vi) House keeping – This is another sensitive area. This will include verification of balancing of all ledgers and registers, inter-branch reconciliation, bank reconciliation, test calculations and verification of interest, discount, commission and exchange income, vouchers for expenses, transactions with staff members, reconciliation of clearing differences, reconciliation of suspense and other sensitive accounts, debit balances in savings accounts and Temporary Overdrafts.
- (vii) Special effort to detect revenue leakage should be made.
- (viii) Special attention to be paid to all fraud prone areas. The attempt should be to ensure that effective measures are taken to prevent frauds. In spite of these measures, if some

manipulation is done by any staff or outside party, the auditor should be able to detect the same as early as possible so that further damage is prevented and timely action is taken.

- (ix) Verification of high value transactions.
- (x) Procedure for safe custody of security forms with the branch.
- (xi) Whether all procedures for tax deduction at source from salaries, rent, interest, professional fees, etc. are followed and tax deducted is deposited with Government in time.
- (xii) Verification of statements, H.O. Returns, statutory returns, calculation of capital adequacy ratio, and compliance with requirements of government business (collection of tax and disbursements).
- (xiii) Study of RBI and internal inspection reports, statutory auditor's report, LFAR relating to branch, etc. and compliance thereto.
- (xiv) Whether customers' complaints are dealt with promptly.

11.8.2 Concurrent audit system in commercial banks -

1. It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

2. The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

(A) Scope of concurrent audit: Concurrent audit is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. It attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. There is an emphasis in favour of substantive checking in key areas rather than test checking. This audit is essentially a management process integral to the establishment of sound internal accounting functions and effective controls and setting the tone for a vigilance internal audit to preclude the incidence of serious errors and fraudulent manipulations.

A concurrent auditor may not sit in judgement of the decisions taken by a branch manager or an authorised official. This is beyond the scope of concurrent audit. However, the audit will necessarily have to see whether the transactions or decisions are within the policy parameters laid down by the Head Office, they do not violate the instructions or policy prescriptions of the RBI, and that they are within the delegated authority.

In very large branches, which have different divisions dealing with specific activities, concurrent audit is a means to the incharge of the branch to ensure on an on going basis that

11.70 Advanced Auditing and Professional Ethics

the different divisions function within laid-down parameters and procedures.

(B) Coverage of business/branches

- (i) The Departments/Divisions at the Head Office dealing with Treasury functions viz investments, funds management including inter-bank borrowings bill rediscount and foreign exchange business are to be subjected to concurrent audit. In addition, all branch offices, undertaking such business and dealing rooms have to be subjected to continuous audit.
- (ii) The coverage of branches should ensure that concurrent audit covers:
 - (a) Branches whose total credit and other risk exposures aggregate to not less than 50% of the total credit and other risk exposures of the bank; and
 - (b) Branches whose aggregate deposits cover not less than 50% of the aggregate deposits of the Bank.
- (iii) To achieve these twin criteria it is suggested that branches may be listed according to credit and other risk exposures and selected in the descending order of exposures to achieve a 50% coverage. If the deposits of these branches do not aggregate to 50% of the Bank's deposits, additional branches in descending order of deposits may be added to achieve a 50% coverage of the branches.
- (iv) While complying with the above parameters, it is necessary to ensure that the coverage encompasses:
 - ◆ exceptionally large branches
 - ◆ very large and large branches
 - ◆ special branches handling foreign exchange business, merchant banking business, large corporate wholesale banking business and forex dealing room operations
 - ◆ large problem branches rated as poor/very poor
 - ◆ Head Office department dealing with treasury/funds management and handling investment portfolio
 - ◆ any other branches or departments where in the opinion of the Bank concurrent audit is desirable.
- (v) Branches subjected to concurrent audit should not normally be included for revenue/income audit.

(C) Types of activities to be covered

- (1) The main role of concurrent audit is to supplement the efforts of the bank in carrying out simultaneous internal check of the transactions and other verifications and compliance with the procedures laid down.
- (2) The scope of concurrent audit should be wide enough to cover certain fraud-prone areas like handling of cash, deposits, safe custody of securities, investments, overdue bills, exercise of discretionary powers, sundry and suspense accounts, inter-branch

reconciliation, clearing differences, foreign exchange business including Nostro accounts, off-balance sheet items like letters of credit and guarantee, treasury functions and credit-card business.

- (3) The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Inspector and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB).
- (4) In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.
- (5) While the detailed scope of the concurrent audit may be determined and approved by the ACB.

(D) Appointment of Auditors and accountability

- (i) The option to consider whether concurrent audit should be done by bank's own staff or external auditors is left to the discretion of individual banks.
- (ii) In case the bank has engaged its own officials, they should be experienced, well trained and sufficiently senior. The staff engaged on concurrent audit must be independent of the branch where concurrent audit is conducted.
- (iii) Appointment of an external audit firm may be initially for one year and extended up to three years - after which an auditor could be shifted to another branch subject to satisfactory performance.
- (iv) If external firms are appointed and any serious acts of omissions or commissions are noticed in their working their appointments may be cancelled and the fact may be reported to RBI & ICAI.

(E) Facilities for effective Concurrent Audit: It has been represented that Concurrent Audit is not often effective because adequate facilities in terms of space, availability of records, etc are not available. To improve the effectiveness of concurrent audit it is suggested that -

- (i) banks arrange for an initial and periodical familiarisation process both for the bank's own staff when entrusted with the concurrent audit and for the external auditors appointed for the purpose;
- (ii) all relevant internal guidelines/circulars/important references as well as relevant circulars issued by RBI/SEBI and other regulating bodies should be made available to the concurrent auditors on an on - going basis;
- (iii) where adequate space is not available, concurrent auditors can commence work immediately after the close of banking hours.

(F) Remuneration - Terms of appointment of the external firms of Chartered Accountants for the concurrent audit and their remuneration may be fixed by banks at their discretion. Broad guidelines should be framed by ACB for these purposes. Suitable packages should be fixed by each bank's management in consultation with its ACB, keeping in view various factors such as coverage of areas, quality of work expected, number of people required for the job, number of hours to be spent on the job, etc.

11.72 Advanced Auditing and Professional Ethics

(G) Reporting Systems

- (i) Concurrent auditors should be attached to the branches and not the zonal offices.
- (ii) Minor irregularities pointed out by the concurrent auditors are to be rectified on the spot. Serious irregularities should be straightaway reported to the controlling offices/ Head Offices for immediate action.
- (iii) There should be zone-wise reporting of the findings of the concurrent audit to ACB and an annual appraisal/report of the audit system should be placed before the ACB.
- (iv) Whenever fraudulent transactions are detected, they should immediately be reported to Inspection & Audit Department (Head Office) as also the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).
- (v) There should be proper reporting of the findings of the concurrent auditors. For this purpose, each bank should prepare a structured format. The major deficiencies/ aberrations noticed during audit should be highlighted in a special note and given immediately to the bank's branch/controlling offices. A quarterly review containing important features brought out during the concurrent audits should be placed before the ACB.
- (vi) Follow-up action on the concurrent audit reports should be given high priority by the controlling office/Inspection and Audit Department and rectification of the features done without any loss of time.
- (vii) A Special Cell in the Inspection and Audit Department may be created in each bank to:
 - (1) review the selection of auditors;
 - (2) initiate and operate a system for the appraisal of the performance on concurrent auditors;
 - (3) ensure that the work of concurrent auditors is properly documented;
 - (4) be responsible for the follow-up on audit reports and the presentation of the quarterly review to the ACB.

Suggested items of coverage are given below:

(A) Cash

- (i) Daily cash transactions with particular reference to any abnormal receipts and payments.
- (ii) Proper accounting of inward and outward cash remittances.
- (iii) Proper accounting of currency chest transactions, its prompt reporting to the RBI.
- (iv) Expenses incurred by cash payment involving sizeable amount.

(B) Investments

- (i) Ensure that in respect of purchase and sale of securities the branch has acted within its delegated power having regard to its Head Office instructions.
- (ii) Ensure that the securities held in the books of the branch are physically held by it.
- (iii) Ensure that the branch is complying with the RBI/head Office guidelines regarding BRs,

SGL forms, delivery of scrips, documentation and accounting.

- (iv) Ensure that the sale or purchase transactions are done at rates beneficial to the bank.

(C) Deposits

- (i) Check the transactions about deposits received and repaid.
- (ii) Percentage check of interest paid on deposits may be made including calculation of interest on large deposits.
- (iii) Check new accounts opened particularly current accounts. Operations in new current/SB accounts may be verified in the initial periods to see whether there are any unusual operations.

(D) Advances

- (i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).
- (ii) Verify whether the sanctions are in accordance with delegated authority.
- (iii) Ensure that securities and documents have been received and properly charged/registered.
- (iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.
- (v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.
- (vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.
- (vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.
- (viii) Ensure proper follow-up of overdue bills of exchange.
- (ix) Verify whether the classification of advances has been done as per RBI guidelines.
- (x) Verify whether the submission of claims to DICGC and ECGC is in time.
- (xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.
- (xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

(E) Foreign Exchange transactions

- (i) Check foreign bills negotiated under letters of credit.
- (ii) Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.

11.74 Advanced Auditing and Professional Ethics

- (iii) Check whether inward/outward remittance have been properly accounted for.
- (iv) Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered.
- (v) Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank.
- (vi) Ensure that the overbought/oversold position maintained in different currencies is reasonable taking into account the foreign exchange operations.
- (vii) Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations.
- (viii) Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.

(F) Housekeeping

- (i) Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper.
- (ii) Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DDDR Account, Drafts Account, etc.
Ensure early adjustment of large value entries.
- (iii) Carry out a percentage check of calculations of interest, discount, commission and exchange.
- (iv) Check whether debits in income account have been permitted by the competent authorities.
- (v) Check the transactions of staff accounts.
- (vi) In case of difference in clearing there is a tendency to book it in an intermediary suspense account instead of locating the difference. Examine the day book to verify as to how the differences in clearing have been adjusted. Such instances should be reported to Head Office in case the difference persists.
- (vii) Detection & prevention of revenue leakages through close examination of income and expenditure persists.
- (viii) Check cheques returned/bills returned register and look into reasons for return of those instruments.
- (ix) Checking of inward and outward remittances (DDs, MTs & TTs).

(G) Other items

- (i) In case the branch has been entrusted with government business, ensure that the transactions are done in accordance with the instructions issued by Government, RBI & HQ.
- (ii) Ensure that the branch gives proper compliance to the internal inspection/audit reports.
- (iii) Ensure that customers' complaints are dealt with promptly.

- (iv) Verification of statements, returns, statutory returns. The aforesaid list is illustrative and not Exhaustive.

11.8.3 Reporting by Concurrent Auditors - Timely reporting is the essence of the concurrent audit. Therefore, depending on the size of the operations in a branch the bank decides to get the audit conducted on a daily basis, monthly basis or quarterly basis. In any of these assignments, the auditor has to cover the entire area of operations. In the case of daily or monthly, audit, the audit report of the work done for a particular work is required to be submitted by the auditor by the 10th of the next month. In the case of quarterly audit the report is to be given by the 10th of the month after the end of the quarter. In the case of any serious irregularity noticed by the auditor while conducting the audit he has to give a flash report immediately so that the bank can take remedial action without any delay. Where monthly reports are given, the auditor is required to give an executive summary of audit report at the end of the each quarter. The auditor has to adhere to this discipline of timely reporting.

A member of the accounting profession has to use his specialised knowledge, skill and experience while drafting his audit report. Normally, the audit report should be divided in three parts. The first part should deal with major irregularities. The second part should deal with minor irregularities which have not been attended during the course of audit. The last part should deal with compliance with earlier reports. All issues pointed out in earlier reports which have not been complied with should be briefly stated in this last part. Items where no irregularities are found need not be stated in the report. Areas covered by the audit for the period covered by the report may be stated in the preamble. The rest of the reporting should be by exception so that only those items which require attention by the bank management are stated in the report.

Before submission of the report the auditor should discuss the important issues on which he wishes to report with the branch manager and concerned officers. This will enable him to take into consideration the opposite view point and clarify his doubts. In the case of a bank where there is four-tier system, that is, Branch, Regional Office, Zonal Office and Central Office, the detailed monthly/quarterly report is to be given to branch manager and regional manager. Quarterly executive summary is to be given to all the four authorities.

It is also essential for the bank management to take effective steps to study these reports and take remedial action so as to improve the working of the branches. Since this type of audit is conducted at the large branches only, the bank management should view the common irregularities pointed out by the auditors as illustrative and ensure that such irregularities do not take place in other branches which are not under concurrent audit. It is also essential that periodical meetings are held by the regional managers with the concurrent auditors. This will enable them to know the views of the auditors on certain important issues covering their audit assignments.

11.8.4 Audit Committee - In pursuance of RBI circular September 26, 1995, a bank is required to constitute an Audit Committee of its Board. The membership of the audit committee is restricted to the Executive Director, nominees of the Central Government and the RBI, Chartered Accountant director and one of the non-official directors.

One of the functions of this committee is to provide direction and also oversee the operations

11.76 Advanced Auditing and Professional Ethics

of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow up. The committee has to review the system of appointment and remuneration of concurrent auditors.

The Audit Committee is, therefore, connected with the functioning of the system of concurrent audit. The method of appointment of auditors, their remuneration and the quality of their work is to be reviewed by the Audit Committee. It is in this context that periodical meetings by the members of the audit committee with the concurrent auditors and statutory auditors help the audit committee to oversee the operations of the total audit function in the bank.

Considering the coverage of this audit assignment and the specialised nature of work there is also a need for training to be imparted to the staff of the auditors. This training has to be given in specialised fields such as foreign exchange, computerisation, areas of income leakage, fraud prone areas, determination of credit rating and other similar specialised areas. The bank can organise such training programmes at various places so that it can ensure the quality of audit.

Audit of General Insurance Companies

12.1 Introduction

The general insurance business in India is governed by the Insurance Act, 1938 which is based on the British Insurance Act. The Act was amended in 1969 for social control to govern the general insurance business on healthy lines. However, it was felt that there still existed some scope for improvement. In view of this, on May 13, 1971 the government nationalised the general insurance industry by an ordinance which became the General Insurance (Nationalisation) Act, 1972. At that time, 107 companies were taken over by the Government and accordingly the General Insurance Corporation (GIC) was formed as a government company on November 22, 1972. The insurers were grouped into four companies viz., the Oriental Insurance Co. Ltd., the National Insurance Company Ltd., the New India Assurance Company Ltd. and the United India Insurance Company.

The Government of India, with a view to achieving effective regulation, decided to establish a regulator of the insurance industry. The decision of the Government was translated into reality by the enactment of Insurance Regulatory and Development Authority (IRDA) Act in the year 1999. The Insurance Regulatory and Development Authority Act, 1999 (Authority in brief) provided for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto. The Authority has been assigned the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

As defined under the Insurance Act, 1938, 'general insurance business' means fire, marine or miscellaneous insurance business, whether carried on singly or in combination with one or more of them.

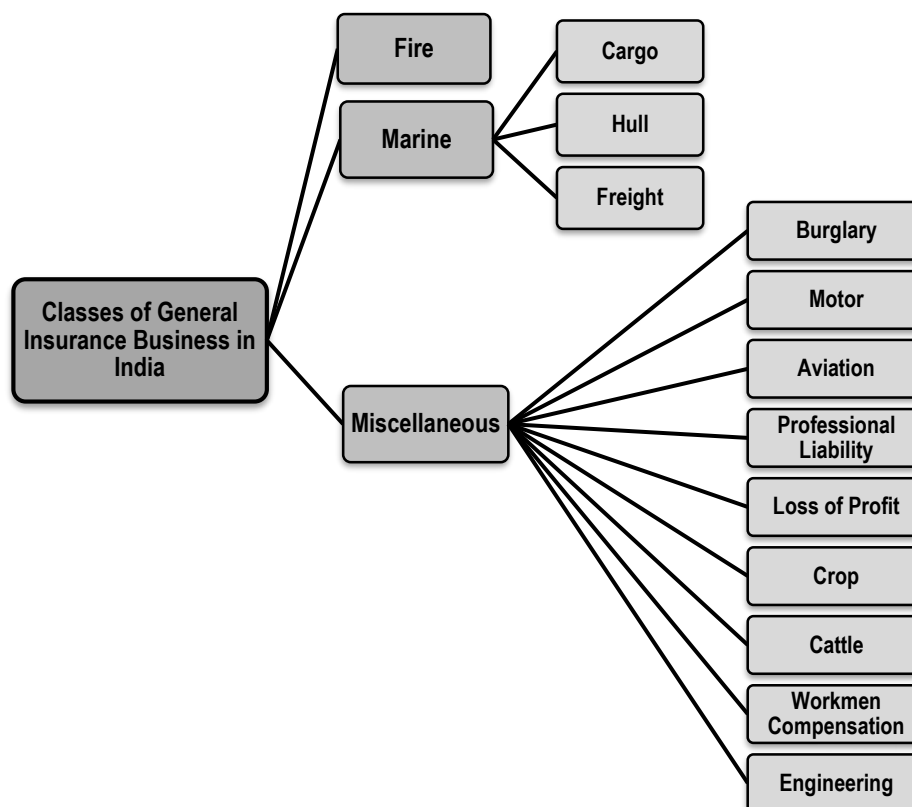


Diagram showing classes of General Insurance Business

12.2 Legal Framework

It is important for the auditor to familiarise himself with various statutes governing the insurance industry. The auditor, while familiarising himself with various rules, regulations, relevant notifications should also look into the important aspects arising out of those which might have an effect on determination of nature, timing and extent of audit procedures, while performing his role as an auditor.

The primary legislations which deal with the insurance business in India are the Insurance Act, 1938 and the IRDA Act, 1999. Various aspects relating to audit are dealt with around the framework of the following statutes and rules made thereunder:

- (a) The Insurance Act, 1938 as amended by the Insurance Laws (Amendment) Act, 2015 (including Insurance Rules, 1939);
- (b) The Insurance Regulatory and Development Authority Act, 1999 as amended by the Insurance Laws (Amendment) Act, 2015;

- (c) The Insurance Regulatory and Development Authority Regulations framed under the IRDA, Act, 1999;
- (d) The Companies Act, 2013; and
- (e) The General Insurance Business (Nationalisation) Act, 1972 as amended by the Insurance Laws (Amendment) Act, 2015 (including Rules framed thereunder).

Some relevant statutory provisions are discussed below:

Insurer - Section 2(9) of the Insurance Act, 1938 defines the term 'Insurer' as:

- (a) an Indian Insurance Company, or
- (b) a statutory body established by an Act of Parliament to carry on insurance business, or
- (c) an insurance co-operative society, or
- (d) a foreign company engaged in re-insurance business through a branch established in India.

It may be noted that a "foreign company" shall mean a company or body established or incorporated under a law of any country outside India and includes Lloyd's established under the Lloyd's Act, 1871 (United Kingdom) or any of its Members.

Policy Holder - Section 2(2) of the Insurance Act, 1938 defines the term policy holder as a person to whom the whole of the interest of the policy holder in the policy is assigned once and for all, but does not include an assignee thereof whose interest in the policy is defensible or is for the time being subject to any condition.

Prohibition of Insurance Business by Certain Persons - Third proviso to section 2C(1) of the Insurance Act, 1938 (inserted by the IRDA Act, 1999) prohibits persons other than an Indian insurance company to begin to transact the insurance business after the commencement of the IRDA Act, 1999.

Thus, the enterprises that were engaged in the insurance business prior to the commencement of the IRDA Act, 1999 continue to exist but a new insurance industry entrant can only be an Indian insurance company. However, an insurance co-operative society was allowed to carry on any class of insurance business on or after the commencement of the Insurance (Amendment) Act, 2002.

The definition of Indian Insurance Company given under section 2(7A) of the Insurance Act, 1938 is reproduced hereunder:

"Indian insurance company" means any insurer, being a company which is limited by shares, and,-

- (a) which is formed and registered under the Companies Act, 2013 as a public company or is converted into such a company within one year of the commencement of the Insurance Laws (Amendment) Act, 2015.

12.4 Advanced Auditing and Professional Ethics

- (b) in which the aggregate holdings of equity shares by foreign investors, including portfolio investors, does not exceed 49% of the paid up equity capital of such Indian Insurance company, which is Indian owned and controlled, in such manner as may be prescribed.

Here, the expression 'control' shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements.

- (c) whose sole purpose is to carry on life insurance business or general insurance business or re-insurance business or health insurance business.

Registration of Indian Insurance Companies - Section 3 of the Insurance Act, 1938 requires every insurer to obtain a certificate of registration before commencement of insurance business in India. The section empowers the Authority to make regulations for registration of insurers. It may be noted here that no insurer other than an Indian insurance company can commence the insurance business after the enactment of the IRDA Act, 1999. The registration of Indian insurance companies is done in accordance with the IRDA (Registration of Indian Insurance Companies) Regulations, 2000.

Requirements as to the Minimum Paid-up Capital - The minimum paid-up equity share capital of an Indian insurance company carrying on general insurance business should be ₹ 100 crores excluding preliminary expenses incurred in the formation and registration of company. The insurer may enhance the same in accordance with the provisions of the Companies Act, 2013, SEBI Act, 1992 and the rules, regulations or directions issued thereunder or any other law for the time being in force.

12.3 Insurance Regulatory and Development Authority (IRDA) Act, 1999 and Regulations framed thereunder

As mentioned earlier, the IRDA Act, 1999 has established the Insurance Regulatory and Development Authority (the Authority) and has also provided for establishment of the Insurance Advisory Committee to advise the Authority on various matters. The IRDA Act, 1999 has also made amendments to the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972 by insertion of the First, Second and Third Schedules to the IRDA Act, 1999. These Schedules contain amendments to rationalise the provisions of the Insurance Act, 1938 and other statutes with the IRDA Act, 1999 and the Regulations.

12.4 Features of Accounting System of Insurance Companies

The system of recording, classifying and summarising the transactions in insurance companies, is, in substance, no different from other entities. However, in case of insurance companies, the ledger accounts specially those of premiums, claims, commissions, etc. need to be given greater attention. The functions of accounting system in general insurance business under IT environment may be based on:

- ◆ Underwriting module

- ◆ Claims module
- ◆ Agency management module
- ◆ Accounts module
- ◆ Investment module
- ◆ Reinsurance module

Every insurer, in respect of insurance business transacted and in respect of shareholder's funds, is required to prepare a Balance Sheet, a Profit and Loss Account, a separate Account of Receipts and Payments, a Revenue Account for each year in accordance with the Regulations as may be specified. Every insurer should keep separate accounts relating to funds of shareholders and policyholders.

12.4.1 Form and Contents of Financial Statements

Section 11 of the Insurance Act, 1938 provides that every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act, 2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall, at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.

The Authority, in pursuance of the powers conferred to it by the provisions of section 114 A of the Insurance Act, 1938, has issued regulations for the preparation of the financial statements and auditor's report of companies carrying on insurance business. The Regulations contain three schedules. Schedule A is applicable to companies carrying on life insurance business. Schedule B of the Regulations lays down the accounting principles, disclosures forming part of financial statements, general instructions for preparation of financial statements, the contents of the management report and the formats in which the financial statements of an insurer carrying on general insurance business should be drawn up. Schedule B is in five parts, covering various aspects related to the preparation of financial statements, which form the main basis for preparation of financial statements of general insurance companies. The five parts have been outlined in the following paragraphs. Schedule C to the Regulations lays down the matters to be dealt with by the auditor's report of an insurance company. Schedule C is applicable to insurers carrying on general insurance business as well as life insurance business.

12.4.2 Requirements of Schedule B to the IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002

Part I: Accounting Principles for Preparation of Financial Statements

1. Applicability of Accounting Standards
2. Premium
3. Premium Deficiency
4. Acquisition Costs

12.6 Advanced Auditing and Professional Ethics

5. Claims
6. Procedure to determine the value of investments
7. Loans
8. Catastrophe Reserve

Part II: Disclosures forming part of Financial Statements

Part III: General Instructions for Preparation of Financial Statements

Part IV: Contents of Management Report

Part V: Preparation of Financial Statements

For details along with format of the above, students may refer Chapter 5 of Paper 5- Advanced Accounting, Intermediate (IPC) Study Material.

Audit Considerations - As mentioned earlier, Schedule C to the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 prescribes the matters to be dealt with by the auditor's report. The auditors under clause (3) of Schedule C to the Regulations are required to certify that they have reviewed the management report and there is no apparent mistake or material inconsistencies in the management report with the financial statements. The auditors are also required to certify that the insurer has complied with the terms and conditions of the registration stipulated by the Authority.

From the foregoing, it is clear that the auditor has to examine the contents of the management report with a view to certify that there are no material inconsistencies in the same with the financial statements. The auditor should, based upon the audit conducted and information and explanations gathered during the course of the audit, verify that there are no material misstatements in the management report. As far as certification of compliance with the terms and conditions of the registration stipulated by the Authority is concerned, the auditor should ask for the relevant documents from the management of the company and conduct an examination thereof. Based on his observation, the auditor should certify the aforesaid compliance.

12.4.3 Signatures and Reports to be attached with the Accounts and Statements

Sub-section (3) of section 11 of the Insurance Act, 1938 provides that the accounts and statements referred to in sub-section (1) should be signed, in the case of a company, by the chairman, if any, and two directors and the principal officer of the company. It further provides that the accounts and statements should be accompanied by a statement containing the names, descriptions and occupations of, and the directorships held by, the persons in charge of the management of the business during the period to which such statements refers and by a report on the affairs of the business during that period.

12.4.4 Requirements of the Insurance Act, 1938 vis a vis the Companies Act, 2013

Disclosures under the Companies Act, 2013 relating to the Balance Sheet and Profit and Loss Account of the company also apply to an insurance company.

Proviso to sub-section (1) of section 129 of the Companies Act, 2013 provides that the financial statements of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose, in the case of an insurance company, any matters which are not required to be disclosed under the Insurance Act, 1938, or the IRDA Act, 1999. However, if an insurance company so desires, it may disclose the information not required to be disclosed under the Insurance Act, 1938.

According to section 1 of the Companies Act, 2013, the provisions of the Companies Act, 2013 shall apply to insurance companies, except in so far as the said provisions are inconsistent with the provisions of the Insurance Act, 1938 or the IRDA Act, 1999. Section 117 of Insurance Act, 1938, provides that nothing in the Insurance Act, 1938 shall affect the liability of an insurer, being a company, to comply with the provisions of the Companies Act, 2013 in matters not otherwise specifically provided for by Insurance Act, 1938. Therefore, the provisions of the Companies Act, 2013 would be applicable wherever the Insurance Act, 1938 does not cover the relevant aspects and the insurer is a company within the meaning of the Companies Act, 2013. The provisions of the Companies Act, 2013 should be applied in a harmonised manner with the provisions of the Insurance Act, 1938, and the rules and regulations framed thereunder.

12.4.5 Accounting Policies

The IRDA Regulations on preparation of financial statements and auditor's report specify that the following accounting policies should form an integral part of the financial statements:

- (a) All significant policies in terms of Accounting Standards issued by the Institute of Chartered Accountants of India, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies followed by the insurer should be stated in the manner required under AS -1 issued by the Institute of Chartered Accountants of India.
- (b) Any departure from the accounting policies as aforesaid is required to be separately disclosed with reasons for such departure.

In connection with the matters in respect of which the auditor has to express an opinion as prescribed in Schedule C to the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002, the auditor has to report whether the financial statements are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 2013 to the extent applicable and in the manner so required.

12.5 Audit of Accounts

Under section 12 of the Insurance Act, 1938, the financial statements of every insurer are required to be audited annually by an auditor. Section 2(4) of the Insurance Act, 1938 defines the term 'auditor' as a person qualified under the Chartered Accountants Act, 1949 to act as an auditor of a company. The auditor, for audit of financial statements, has the powers to exercise the rights vested in, and discharge the duties and be subject to the liabilities and penalties imposed on auditors of companies under the Companies Act, 2013.

12.8 Advanced Auditing and Professional Ethics

The provisions of section 12 of the Insurance Act, 1938 apply only in a case where the financial statements of the insurer are not subject to audit under the Companies Act, 2013. A company carrying on general insurance business is subject to audit requirements laid down under the Companies Act, 2013.

The financial statements under section 12 include Balance Sheet, Profit and Loss Account, Revenue Account. Section 12 of the Insurance Act, 1938 does not cover the requirement for audit of the Receipts and Payments Account of an insurer. However, sub-section (1) of section 11 of the Insurance Act, 1938 requires that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare, at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate Account of Receipts and Payments and a Revenue Account in accordance with the regulations as may be specified. Since Receipts and Payments Account has been made a part of financial statements of an insurer, it is implied that the Receipts and Payment Account is also required to be audited.

The Authority, in exercise of the powers conferred by the Insurance Act, 1938, issued the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002. These Regulations require the auditor of an insurance company to report whether the Receipts and Payments Account of the insurer is in agreement with the books of account and returns. The auditor is also required to express an opinion as to whether the Receipts and Payments Account has been prepared in accordance with the provisions of the relevant statutes and whether the Receipts and Payments Account gives a true and fair view of the receipts and payments of the insurer for the period under audit. This also implies that the auditor is required to audit the Receipts and Payments Account of the insurer.

12.5.1 Appointment of auditors

The appointment of statutory auditors in the General Insurance Corporation of India, and its subsidiaries and the divisions is made by the Comptroller and Auditor General of India, as in the case of other public sector undertakings (For example, in the case of New India Assurance Company Ltd., United India Insurance Company Ltd.). However, in the case of others, auditor is appointed at the AGM (For example, in the case of Bajaj Allianz General Insurance Co. Ltd., ICICI Lombard General Insurance Co. Ltd., Cholamandalam General Insurance Co. Ltd.).

12.5.2 Remuneration of Auditors

The remuneration of auditor of an insurance company is to be fixed in accordance with the provisions of section 142 of the Companies Act, 2013 in the general meeting or in such a manner as the company in general meeting may determine.

12.5.3 Rights and duties of Branch Auditors

It is a practice that the divisional offices prepares a trial balance in a manner that it provides information required to be included in the various formats of financial statements prescribed in the Insurance Act. Each trial balance, in which are incorporated the figures relating to the branches of the divisions, is required to be audited and the report thereon is furnished to the statutory auditors. The divisions of the companies carrying on general insurance business are treated for the purposes of the Companies Act, 2013 as their branches. It follows that the branch

auditors appointed to conduct the audit of the divisions have the same rights and obligations under the statute as those of the, statutory auditors to whom they are expected to submit their report.

12.5.4 Investment Risk Management Systems and Process Audit

The IRDA vide Circular No. INV/CIR/008/2008-09 Dt. 22nd Aug, 2008 advised that the Chartered Accountants firm, which is not the Statutory or Internal or Concurrent Auditor of the concerned Insurer shall certify that the Investment Risk Management Systems and Processes are in place. For this purpose, the ICAI has also issued "Technical Guide on Review and Certification of Investment Risk Management Systems and Processes of Insurance Companies" in consultation with the IRDA.

12.5.5 Auditors' Report

The Authority has prescribed the matters to be dealt with by the Auditors' Report vide Regulation 3 under Schedule C of IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002. The Schedule C is reproduced below -

"The report of the auditors on the financial statements of every insurer shall deal with the specified herein -

1. (a) That they have obtained all the information and explanations which, to the best of their knowledge and belief, were necessary for the purposes of their audit and whether they have found them satisfactory;
 - (b) Whether proper books of account have been maintained by the insurer so far as appears from an examination of those books;
 - (c) Whether proper returns, audited or unaudited, from branches and other offices have been received and whether they were adequate for the purpose of their audit;
 - (d) Whether the Balance Sheet, Revenue Accounts and Profit and Loss Account dealt with by the report and the Receipts and Payments Account are in agreement with the books of account and returns;
 - (e) Whether the actuarial valuation of liabilities is duly certified by the appointed actuary, including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the authority and/or the Actuarial Society of India in concurrence with the Authority.
2. The auditors shall express their opinion on:
 - (a) (i) Whether the Balance Sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period;
 - (ii) Whether the Revenue Account gives a true and fair view of the surplus or the deficit for the financial year/period;
 - (iii) Whether the Profit and Loss Account gives a true and fair view of the profit or loss for the financial year/period;

12.10 Advanced Auditing and Professional Ethics

- (iv) Whether the Receipts and Payments Account gives a true and fair view of the receipts and payments for the financial year/period;
 - (b) The financial statements stated at (a) above are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 1956 (1 of 1956) [now Companies Act, 2013], to the extent applicable and in the manner so required.
 - (c) Investments have been valued in accordance with the provisions of the Act and the Regulations.
 - (d) The accounting policies selected by the insurer are appropriate and are in compliance with the applicable Accounting Standards and with the accounting principles, as prescribed in these Regulations or any order or direction issued by the Authority in this behalf.
3. The auditors shall further certify that:
- (a) they have reviewed the management report and that there is no apparent mistake or material inconsistencies with the financial statements; and
 - (b) the insurer has complied with the terms and conditions of the registration stipulated by the Authority.
4. A certificate signed by the auditors (which is in addition to any other certificate or report which is required by law to be given with respect to the balance sheet) certifying that:
- (a) they have verified the cash balances and the securities relating to the insurer's loans, reversions and life interests (in the case of life insurers) and investments;
 - (b) the extent, if any, to which they have verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and
 - (c) no part of the assets of the policyholders' funds has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investments of the policyholders' funds."

Students may also note that auditors are required to follow the format of report prescribed by the Institute.

12.5.6 Direction of C&AG

The Comptroller and Auditor General of India has the power to direct the manner in which the accounts shall be audited and give such instructions in regard to any matter relating to performance of functions by the auditor and to conduct the supplementary or test audit of the accounts of such companies by such person or persons as may be authorised in this behalf. For the purposes of such audit, the C&AG may require information or additional information on such matters and in such form as may be directed by him in terms of Section 143(5) and 143(6) of the Companies Act, 2013. The statutory auditors are required to submit a copy of their report to the C&AG who has the right to comment upon or supplement the audit report.

12.5.7 Applicability of CARO, 2016

The additional reporting requirement under Companies (Auditor's Report) Order, 2016 is exempted for an insurance company as defined under the Insurance Act, 1938.

12.6 Specific Control Procedures Related to General Insurance Business

The internal control functions have been categorised below under main operational cycles considering the nature of general insurance business. Areas where the internal controls are similar to the ones adopted by other companies such as for cash and bank receipts and payments and fixed assets, have been dealt in the Internal Control Questionnaire, published by the Institute of Chartered Accountants of India. Since various operational cycles are inter-linked, the internal controls operating within the systems of such cycles should be reviewed simultaneously.

12.6.1 Underwriting

The underwriting function, which comprises of examination and evaluation of applications for insurance, the rating of risks and the establishment of premiums, is fundamental to the operations of a general insurance company. The prime objectives of an internal control system for underwriting is adherence to guidelines for acceptances of insurance, proper recording of insurance risk and its evaluation.

12.6.2 Premium

Premium is the consideration received by an insurer from the insured under an insurance contract, whereby the insurer agrees to undertake certain sum of risk on behalf of the insured. The objectives of internal controls over premium is to ensure that correct premium is calculated and collected before acceptance of any risk, that premium is accounted for in an appropriate manner and that the premium is collected only in respect of such risks which are assumed by the company.

12.6.3 Commission

The commission is the consideration payable for getting the insurance business. The term 'commission' is used for the payment of consideration to get Direct business. In case of reinsurance, the term used is 'Commission on reinsurance accepted'. The internal control with regard to commission is aimed at ensuring that commission is paid in accordance with the rules and regulations of the company and in accordance with the agreement with the agent, commission is paid to the agent who brought the business and the legal compliances, for example, tax deduction at sources and provisions of the Insurance Act, 1938 have been complied with.

12.6.4 Reinsurance

The key control objectives generally associated with reinsurance transaction involve determination of correct amounts for reinsurance ceded, proper valuation of assets and liabilities

12.12 Advanced Auditing and Professional Ethics

arising out of reinsurance transactions and adherence to legal provisions, regulations and reinsurance agreements.

12.6.5 Claims

A demand for payment of policy benefit because of the occurrence of an insured event is known as 'claim'. Cost of claims to the company includes all the expenses incurred in settlement of claims. Internal controls are established over claims to ensure that only *bonafide* claims are paid. Cost of claims are properly recorded and disclosed in the financial statements.

12.7 Audit Procedures

The important part of the business operations of general insurance companies comprises the issuance of policies for risks assumed and to indemnify the insured for losses to the extent covered by such policies. In financial terms, these operations get translated into the receipt and recording of premiums and the recording and settlement of claims. Both premiums and claims have a significant impact on the insurance companies' revenues, it would be an important part of the duty of the auditor to satisfy himself that the financial transactions involving both these operations have been fairly and properly recorded in the relevant books of account. The auditor should also ensure that the legal requirements as to the disclosure of these items are complied with in the financial statements.

12.7.1 Premium

Insurance premium is collected upon issuing policies. It is the consideration for bearing the risk by the insurance company. The assumption of the risk starts on the issue of receipt based on the acceptance of proposal form or cover note by the respective underwriting department. This receipt is recorded as the premium income in the books of the insurance company. Premium may be accepted either in cash/cheque/Demand Draft/pay order, bank guarantee, cash deposit, etc. The premium collections are credited to a separate bank account and no withdrawals are normally permitted from that account for meeting the general expenditure. As per the policy of the insurance company, the collections are transferred to the Regional Office or Head Office. As soon as the insurance policy is issued, an entry is made in the Register of Policies showing all the relevant details.

No Risk Assumption without Premium - No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

Verification of Premiums - Verification of premium is of utmost importance to an auditor. The auditor should apply, inter alia, the following procedures for verification of premium -

- (i) Before commencing verification of premium income, the auditor should look into the internal controls and compliance thereof as laid down for collection and recording of the premiums.
- (ii) The auditor should ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business. The auditor should also verify that there is an adequate internal check on the issue of stationery comprising of cover notes, policy documents, stamps, etc. The auditor may apply sampling techniques for verification of larger volume of transactions.
- (iii) The auditor should ensure that premium in respect of risks incepting during the relevant accounting year has been accounted as premium income of that year on the basis of premium revenue recognition. The auditor, as part of his audit procedures, should make an assessment of the reasonability of the risk pattern established by the management. The auditor should also see whether the premium received during the year but pertaining to risk commencing in the following year has been accounted for under the head 'Premium Received in Advance' and has been disclosed separately. Normally, such instances relate to the issue of cover notes and certificates at the end of the accounting year relating to risks commencing in the next accounting period. Generally, there is a column in the Premium Register called "Commencement of Risk", indicating the date and time from which the risk under the policy issued has commenced. The auditor should verify that policy documents have not been issued, or where issued, the company was not at risk, in case:
 - (a) premium had not been collected at all;
 - (b) premium had been collected but the relevant cheques have been dishonoured; (refer Cheque Dishonoured Book);
 - (c) premium had not immediately been collected due to furnishing of a bank guarantee or cash deposit but either the deposit or guarantee had fallen short or has expired or the premium had been collected beyond the stipulated time limit (i.e., there is a shortfall in bank guarantee account or cash deposit account of the insured);
 - (d) premium had not been collected due to risk cover being increased or where stipulated limits have been exhausted in respect of open declaration policies (i.e., where premium has accrued but has not been received); and
 - (e) instalments of premium have not been collected in time in respect of certain categories of policies, e.g., marine-cum-erection policies where facility has been granted for premium being paid in instalments (such facility is normally available subject to certain conditions, e.g., that the first equated instalment is more by 5 per cent of the total premium payable by instalments).
- (iv) The auditor should examine whether the reinsurance company is not under a risk in respect of amount lying at credit and outstanding as at the year-end in the following accounts:
 - (a) Deposit Premium Account;
 - (b) Premium Received in Advance Account;

12.14 Advanced Auditing and Professional Ethics

- (c) Inspectors' Deposits Account; and
- (d) Agent's Premium Accounts
- (v) The auditor should verify the collections lodged by agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit. The auditor should also check that the premium has been recorded originally at the gross figure, i.e., without providing for unexpired risks and reinsurances.
- (vi) In case of co-insurance business, where the company is not the leader, because of the non-availability of the relevant information in many cases the premium is not booked even though the risk has commenced during the relevant accounting year. The auditor should see that the company's share of the premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer. The auditor should examine the communications issued to the company by the leading insurers advising them of the company's share of premium income. Such communications should be seen even in respect of the post-audit period. Where the company is the leader, the auditor should obtain a reasonable assurance that only the company's own share of premium has been shown as income and accounts of the other companies have been credited with their share of the premium collected.
- (vii) The auditor should check whether Premium Registers have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advice on a day-to-day basis. The auditor should verify whether the figures of premium mentioned in the register tally with those in General Ledger.
- (viii) Where policies have been issued with a provision to collect premium periodically (i.e., under instalment clause, special declaration policy or periodical declaration under open policies in marine insurance), the auditor should check whether premium are collected as and when they become due.
- (ix) The auditor should verify whether instalments falling due on or before the balance sheet date, whether received or not, have been accounted for as premium income as for the year under audit. Also examine whether instalments of premium falling due in the subsequent year have not been recognised in the accounts as outstanding premium.
- (x) The auditor should verify the year end transactions to check that amounts received during the year in respect of risks commencing/ instalments falling due on or after the first day of next financial year are not credited to premium account but credited to Premium Received in Advance Account.
- (xi) The auditor should verify the collections remitted by agents immediately after the cut-off date to verify the risk assumed during the year under audit on those collections.
- (xii) The auditor should also check that in case of cancellation of policies/cover notes issued, no risk has been assumed between the date of issue and subsequent cancellation thereof.
- (xiii) Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.

- (xiv) The auditor should verify whether service tax has been charged from the insured, at the rates in force, on the total premium for all classes of business other than those exempted under service tax laws. Check whether service tax so collected is disclosed under 'Current Liabilities' to the extent not deposited in Government's Account.
- (xv) In the case of co-insurance business, the auditor should verify whether service tax at the rates in force on the whole premium has been charged or collected from the insured by the company in case it is the leader.

Check that service tax so collected on premium charged from the insured by the company have been regularly deposited in the Government's Account.

12.7.2 Claims

The components of the cost of claims to an insurer comprise the claims under policies and claim settlement costs. Claims under policies comprise the claims paid for losses incurred, and those estimated or anticipated claims pending settlements under the policies. Settlement cost of claims includes surveyor fee, legal expenses, etc. A liability for outstanding claims should be brought to account on the following:

- (i) Direct Business;
- (ii) Inward Reinsurance Business; and
- (iii) Co-Insurance business

The liability includes future payments in relation to unpaid reported claims and claims incurred but not reported including inadequate reserves which would result in future cash or asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liabilities for outstanding claims in respect of claims under policies, whether due or intimated at the beginning and at the end of the financial period. The accounting estimate also includes claims cost adjusted for salvage value if there is sufficient degree of certainty of its realisation.

Registers and Records - The following register and records are generally prepared in respect of claims:

- (i) Claims Intimation Register;
- (ii) Claims Paid Register;
- (iii) Claims Disbursement Bank Book;
- (iv) Claims Dockets, normally containing the following records:
 - Claim intimation, claim form, particulars of policy, survey report, Photograph showing damage, repairer's bills, letter of subrogation, police report, fire service report, claim settlement note, claim satisfaction note, salvage report, salvage disposal note, claims discharge voucher, etc.;
- (v) Report of quality assurance team; and
- (vi) Salvage register.

12.16 Advanced Auditing and Professional Ethics

The Claim Account is debited with all the payments including repair charges, fire fighting expenses, police report fees, survey fees, amount decreed by the Courts, travel expenses, photograph charges, etc. The provision for claims incurred but not reported is not made at Branch/Divisional Office level but at the Head Office level.

Verification of Claims

Claims Provisions - The auditor should obtain from the divisions/branches, the information for each class of business, categorizing the claims value-wise before commencing verification of the claims provisions, so that appropriate statistical sampling techniques may be applied, to ensure that representative volume of claims is verified for each class of business. The auditor should determine the total number of documents to be checked giving due importance to claim provisions of higher value.

The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims. The auditor should satisfy himself that the estimated liability provided for by the management is adequate with reference to the relevant claim files/dockets, keeping in view the following:

- (i) that provision has been made for all unsettled claims as at the year-end on the basis of claims lodged/communicated by the parties against the company. The date of loss (and not the date of communication thereof) is important for recording/ recognizing the claim as attributable to a particular year.

In certain circumstances, the claims are incurred by the insurance company but are not reported at the balance sheet date by the insured. Such claims are known as claims incurred but not reported (IBNR). The auditor should check the records for subsequent periods to ascertain that adequate provision has been created for such claims also.

- (ii) that provision has been made for only such claims for which the company is legally liable, considering particularly, (a) that the risk was covered by the policy, if in force, and the claims arose during the currency of the policy; and (b) that claim did not arise during the period the company was not supposed to cover the risk, e.g., where the premium was not paid or where cheques covering premium have been dishonoured (refer section 64VB of the Insurance Act, 1938) or where a total loss under a policy has already been met/settled.
- (iii) that the provision made is normally not in excess of the amount insured except in some categories of claims where matters may be sub-judice in legal proceedings which will determine the quantum of claim, the amount of provision should also include survey fee and other direct expenses.
- (iv) that in determining the amount of provision, events after the balance sheet date have been considered, e.g., (a) claims settled for a materially higher/lower amount in the post-audit period; (b) claims paid by other insurance companies during the year under audit and communicated to company after the balance sheet date where other companies are the leaders in co-insurance arrangements; and (c) further reports by surveyors or assessors.

- (v) that the claims status reports recommended to be prepared by the Divisional Manager on large claims outstanding at the year-end have been reviewed with the contents of relevant files or dockets for determining excess/short provisions. The said report should be complete as to material facts to enable the auditor to take a fair view of the provision made.
- (vi) that in determining the amount of provision, the 'average clause' has been applied in case of under-insurance by parties.
- (vii) that the provision made is net of payments made 'on account' to the parties wherever such payments have been booked to claims.
- (viii) that in case of co-insurance arrangements, the company has made provisions only in respect of its own share of anticipated liability.
- (ix) that wherever an unduly long time has elapsed after the filing of the claim and there has been no further communication and no litigation or arbitration dispute is involved, the reasons for carrying the provision have been ascertained.
- (x) that wherever legal advice has been sought or the claim is under litigation, the provision is made according to the legal advisor's view and differences, if any, are explained.
- (xi) that in the case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits are stated separately as assets and provisions are not made net of such deposits.
- (xii) that no contingent liability is carried in respect of any claim intimated in respect of policies issued.
- (xiii) that the claims are provided for net of estimated salvage, wherever applicable.
- (xiv) that intimation of loss is received within a reasonable time and reasons for undue delay in intimation are looked into.
- (xv) that provisions have been retained as at the yearend in respect of guarantees given by company to various Courts for claims under litigation.
- (xvi) that due provision has been made in respect of claims lodged at any office of the company other than the one from where the policy was taken, e.g., a vehicle insured at Mumbai having met with an accident at Chennai necessitating claim intimation at one of the offices of the company at Chennai.

In cases of material differences in the liability estimated by the management and that which ought to be provided in the opinion of the auditor, the same must be brought out in the auditor's report after obtaining further information or explanation from the management. For determining the adequacy of the provisions in respect of any category of business, the auditor may resort to the method of testing the actual payments, wherever made, with the provisions made earlier for that category of business. Whether such liability has been estimated in the past on a fair and realistic basis can, thus, be examined by looking into current year's payments against provisions of the earlier year.

Claims Paid - The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows:

12.18 Advanced Auditing and Professional Ethics

- (i) that in case of co-insurance arrangements, claims paid have been booked only in respect of company's share and the balance has been debited to other insurance companies;
- (ii) that in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company. Such claims which have been communicated after the year-end for losses which occurred prior to the year-end must be accounted for in the year of audit;
- (iii) that the claims payments have been duly sanctioned by the authority concerned and the payments of the amounts are duly acknowledged by the claimants;
- (iv) that the salvage recovered has been duly accounted for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure;
- (v) that the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;
- (vi) that payment made against claims partially settled have been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount;
- (vii) that in case of final settlement of claims, the claimant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and
- (viii) that the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

12.7.3 Commission

It is a well-known fact that insurance business is solicited by insurance agents. The remuneration of an agent is paid by way of commission which is calculated by applying a percentage to the premium collected by him. Commission is payable to the agents for the business procured through them and is debited to Commission on Direct Business Account. There is a separate head for commission on reinsurance accepted which usually arise in case of Head Office. It may be noted that under section 40 of Insurance Act, 1938, no commission can be paid to a person who is not an agent of the insurance company.

The auditor should, *inter alia*, do the following for verification of commission:

- (i) Vouch disbursement entries with reference to the disbursement vouchers with copies of commission bills and commission statements.
- (ii) Check whether the vouchers are authorised by the officers-in-charge as per rules in force and income tax is deducted at source, as applicable.
- (iii) Test check correctness of amounts of commission allowed.

(iv) Scrutinise agents' ledger and the balances, examine accounts having debit balances, if any, and obtain information on the same. Necessary rectification of accounts and other remedial actions have to be considered.

(v) Check whether commission outgo for the period under audit been duly accounted.

12.7.4 Operating Expenses related to Insurance Business (Expenses of Management)

All the administrative expenses in an insurance company are broadly classified under 13 heads as mentioned in Schedule 4 forming part of Financial Statements given under Schedule B to the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002. In so far as financial statements are concerned, this Schedule is part of the Revenue Account to be prepared for insurance business. Any other expenses are required to be disclosed under the head 'Others'. Any major expenses (₹ 5 lacs or in excess of 1% of net premium, whichever is higher) are required to be shown separately. Careful reading of the words 'expenses related to insurance business' clearly indicate any expenses which do not have any direct relation to insurance business are to be shown separately in the Profit and Loss Account. Expenses relating to investment department, brokerage, bank charges, transfer fees, etc. do not have a direct relationship to the day-to-day working of the insurance business and as such would not be included in the revenue account.

These expenses are first aggregated and then apportioned to the Revenue Account of each class of business on a reasonable and equitable basis. The accounting policy should clearly indicate the basis of apportionment of these expenses to the respective Revenue Accounts (i.e., fire, marine and miscellaneous) along with the certificate that all expenses of management, wherever incurred, directly or indirectly, read with the accounting policy, have been fully debited to the respective Revenue Account as expenses. Refer to Schedule 4 on Operating Expenses for specific items.

12.7.5 Legal and Professional Charges

As far as legal and professional charges are concerned, attention is drawn to the head 'Claims Incurred' under Schedule 2 where it is clearly stated that survey fees, legal and other expenses should form part of claim cost, and therefore, are not to be included under the head Legal and Professional Charges. Hence, all other expenses which are not covered under the claims cost are required to be included under this head.

12.7.6 Employees' Remuneration and Welfare Benefits

The employees' remuneration includes all kinds of payments made to employees in consideration of their services. The reimbursement of medical expenses or premium in respect of employees' health cover is covered under the employees' remuneration and welfare. Any medical fees incurred towards maintenance of health care policies (which are not for employees) are required to be debited to the claims cost under the health care and not to be included under this head. Any expenses towards medical treatment of employees incurred by the company should also be included under this head. Non training expenses have to be shown separately.

12.7.7 Interest and Bank charges

All expenses incurred towards maintenance of Bank Account, interest and other charges levied by bankers to the normal course of business other than bank expenses relating to investments (interest, bank charges, custodial charges, etc.) are shown under the head, "Interest and Bank Charges". Any other interest charged on the borrowings which could not form part of the Revenue Account not to be included under this head.

12.7.8 Depreciation

Charging of depreciation is governed by Schedule II to the Companies Act, 2013. In addition, compliance of relevant Accounting Standard is also to be taken care.

12.7.9 Interest, Dividend and Rent

An insurance enterprise, like any other, earns interest dividend and rent through its assets. The interest, dividend and rent earned are to be apportioned between Revenue Account and Profit and Loss Account. The Regulations require that basis of allocation of interest, dividend and rent between the Revenue Account and Profit and Loss Account should be clearly indicated in the company's accounting policy. The interest or dividend earned as against the policyholders' funds is required to be apportioned to the Revenue Account. The interest earned on, say, grant of vehicle loans, housing loans, deposits with banks of the shareholders, funds, rent received on let out properties owned by the company, by way of investments shareholders, funds, etc. are required to be shown under the profit and Loss Account.

12.8 Items Relating to Balance Sheet

Following are the broad classes of items in a balance sheet:

12.8.1 Investments

Insurance Companies make investments apart from earning income, to comply with the relevant statutory requirements and also for meeting any unforeseen contingencies and claims. The regulations issued by the authority from time to time affect the quantum of investments, the nature of assets in which investments are to be made.

Investments by general insurance companies are governed by the provisions of section 27, 27A, 27B, 27C, 27D and 27E of the Insurance Act, 1938 as well as by the guidelines issued from time to time by the Ministry of Finance through General Insurance Corporation of India.

Audit Procedures - The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments insofar as non-compliance may have a direct and material effect on the financial statements.

The auditor should verify the investment scrips physically at the close of business on the date the balance sheet. In exceptional cases where physical verification of investment scrips on the balance sheet date is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc.

He should take particular care to see that only genuine investments are produced before him, and that securities held by the insurance company on behalf of others (e.g., those held as security against loans) are not shown to him as the insurance company's own investments. To ensure this, the auditor should – require that all investment scrips in the possession of the insurance company – whether belonging to it or to borrowers should be produced before him simultaneously. The auditor should keep them under his control until he completes his checking. Normally, the investments of an insurance company are held by the insurance company itself or a depository (in the case of dematerialised securities other than government securities).

Investments are normally dealt with at the Head Office and not at the branches. However, sometimes, for realisation of interest, etc. and other similar purposes, investments of an insurance company may be held at Branch Offices also. In such cases, the auditor should examine the record maintained at the Head Office to record details of investments held at other locations and request the respective branch auditors to physically verify such investments as a part of their audit. The auditor should obtain a written confirmation to this effect from the branch auditors. In case the verification has been done on a date other than the balance sheet date, a statement showing the reconciliation of the investments held at the time of physical verification with the investments held as on the balance sheet date should also be obtained from the branch auditors. The branch auditors should report whether adequate records are maintained by the branch for the securities held by it on behalf of the Head Office.

Investments should not normally be held by any other person (as laid down in the City Equitable Fire Insurance Co. case). If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up, etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the insurance company, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security).

In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organisation.

The auditor should also examine whether securities lodged for transfer are received back within a reasonable period. Similarly, he should examine whether share certificates, etc. are received within a reasonable period, of the lodging of the allotment advice. In case there is an unusual delay in registration of transfers, etc., the auditor should see that adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the delays. In cases where the issuer/registrar has refused to register the transfer of securities in the name of the insurance company, the auditor should verify the validity of the title of the insurance company over such securities.

The auditor should examine whether the portfolio of the insurance company consists of any securities whose maturity dates have already expired. It is possible that income on such investments may also not have been received. In case the amount of such investments or the income accrued thereon is material, the auditor should seek an explanation from the

12.22 Advanced Auditing and Professional Ethics

management on this aspect. He should also consider whether any provision for loss on this account is required. Similarly, where income on any security is long overdue, the auditor should consider whether provision is required in respect of such income accrued earlier.

Investments in securities now-a-days constitute a substantial part of total assets of many insurance companies. Method of valuation of investments followed by an insurance company may, therefore, have a significant effect on its Balance Sheet and Profit and Loss Account. The auditor should examine whether the method of accounting followed by the insurance company in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments in the context of the guidelines of the Insurance Regulatory and Development Authority and the accounting policy followed by the insurance company in respect of investments. The auditor should examine the appropriateness of accounting policies followed by the insurance company. In case any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report.

A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet.

The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the insurance company has opted for receipt of income through the Electronic Clearing Service.

There may be cases where the certificates of tax deduction at source (TDS) received along with the interest on investments are found missing. This increases the incidence of tax on the insurance company. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the insurance company.

12.8.2 Cash and Bank Balances

Cash and Bank balances at Branch Office/Divisional Office level also constitute significant items related to balance sheet. The auditor should apply the following audit procedures for verification of claims.

- (i) The auditor should physically verify cash balance collection and imprest for meeting day to day expenditures, postage stamps balance, revenue, policy, licence fees, franking machine balance. The auditor should also obtain a certificate from the management for the above mentioned balances as at the balance sheet date.

If for some reason, the physical verification of the above on the balance sheet date is not possible then the same can be done at a subsequent date and by way of backward calculations, cash in hand at the balance sheet date can be verified.

- (ii) The auditor should also check whether late collections of cash and cheques on the last working day of the financial year, which could not be deposited into bank account on the same day, have been identified and booked as Cash in Hand and Cheques in Hand Account, respectively.
- (iii) The auditor may apply test check on the bank transactions.

- (iv) The auditor should also check Bank Reconciliation statement and long outstanding entries therein.
- (v) The auditor should obtain confirmation of Bank Balances for all operative and inoperative accounts.
- (vi) The auditor should physically verify Term Deposit Receipts issued by bankers.
- (vii) The auditor should verify the deposits and withdrawals transactions at random and check whether the Account is operated by authorised persons only.
- (viii) The auditor should verify the subsequent realisations for all items appearing in the reconciliation.
- (ix) In case of funds, in-transit, he should verify that the same are properly reflected as part of bank balance.

12.8.3 Outstanding Premium and Agents' Balances

The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

- (i) Scrutinise and review control account debit balances and their nature should be enquired into.
- (ii) Examine inoperative balances and treatment given for old balances with reference to company rules.
- (iii) Enquire into the reasons for retaining the old balances.
- (iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
- (v) Check age-wise, sector-wise analysis of outstanding premium.
- (vi) Verify whether outstanding premiums have since been collected.
- (vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

12.8.4 Provision for Taxation

The steps to be conducted by the auditor for audit and verification are given below:

- (i) The auditor should check whether the provision for taxation has been made after taking into account the specific provisions applicable to insurance companies carrying on general insurance business.
- (ii) It should be seen by auditor whether for the purpose of computation not only the profit, as disclosed by the annual accounts, copies of which are required under the Insurance Act, 1938 to be furnished to the Controller of Insurance, is taken but also all the other accounts furnished by the company to the Controller of Insurance is taken into account.
- (iii) The auditor should assess the past trend regarding the approach of the Income Tax Department, the decision of the various appellate forums including the High Court and the Supreme Court *vis-a-vis* the computation made.

12.24 Advanced Auditing and Professional Ethics

- (iv) The compliance with the provisions of Chapter III of the Income Tax Act, 1961 which provides for income which do not form part of total income is also to be seen.
- (v) The auditor should see whether deductions under Chapter VIA of the Income Tax Act, 1961 which provides for deduction have been made in computing total income is properly taken into account.
- (vi) The auditor should examine whether income computation relating to foreign branches and other income earned outside India is dealt with properly as per the double taxation avoidance agreement, if any, entered into with those countries.
- (vii) It should be seen whether the exemption provision relating to tax deducted at source from certain categories of income as exempted under section 35A of the General Insurance (Business Nationalisation) Act, 1972 has been properly availed.
- (viii) Also, the auditor should check whether the grossing up of TDS relating to the income has been properly done for the purpose of computation of taxable income.
- (ix) The auditor should ensure that the provisions of the Income Tax Act, 1961 regarding the tax to be deducted at source have been properly complied with, relating to the payments / credits for which the TDS provisions of the Income Tax Act are applicable and the amount so deducted are remitted within the stipulated time. Also check TDS implication on the interest paid / payable and included on claim settlement / outstanding claims.
- (x) The auditor should see the system of service tax collection and the payment to the statutory authorities and the internal system including the filing of statutory returns.
- (xi) The examination of sales tax implication on the sale of salvage should also be seen as it is applicable to the respective states and the past trend in this regard.
- (xii) The auditor should check the liability under the VAT and whether provision for adequate amount has been made in the books or not.
- (xiii) The auditor should verify that adequate provision has been made for additional liability relating to earlier years for which demands have been received in the current year and where the company has gone into appeal, the fact that no provision has been made and that an appeal has been preferred has to be disclosed in the notes to accounts.

12.8.5 Unexpired Risks Reserve

The need for Unexpired Risks Reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date. Many policies normally extend beyond this date into the following year during which risks continue. In other words, at the closing date, there is unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

As per section 64V of the Insurance Act, 1938, for the purpose of compliance with the provisions of maintaining control level of solvency margin, a proper value of every item of liability of the insurer shall be placed in the manner as may be specified by the regulations made in this behalf.

It may be mentioned that the profit and gain of insurance companies are governed by the provisions of section 44 of the Income Tax Act, 1961. In this regard, Rule 5 of the First Schedule to the Income Tax Act-Computation of Profit & Loss of General Insurance Business provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the Income Tax Rules, 1962. According to this Rule, the insurance companies are allowed a deduction of 50 per cent of net premium income in respect of Fire and Miscellaneous Business and 100 per cent of the net premium income relating to Marine Insurance business.



Fig.: Marine Insurance*



Fig.: Fire Insurance*

12.9 Reinsurance

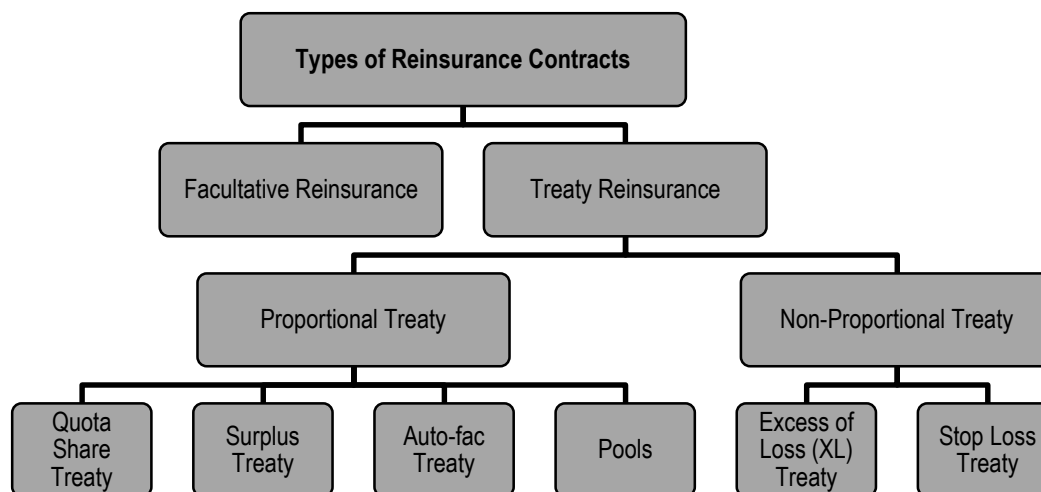
A reinsurance transaction may be defined as an agreement between a 'ceding company' and a 'reinsurer' whereby the former agrees to 'cede' and the latter agrees to accept a certain specified share of risk or liability upon terms as set out in the agreement. A 'ceding company' is the original insurance company which has accepted the risk and has agreed to 'cede' or pass on that risk to another insurance company or the reinsurance company. It may, however, be emphasised that the insured does not acquire any right under a reinsurance contract. In the event of loss, the insured's claim for full amount is against the original insurer only. The original insurer in turn, lodges a claim with the reinsurer.

12.9.1 Type of Reinsurance Contracts

There are broadly two types of reinsurance contracts, viz., facultative reinsurance and treaty reinsurance. A diagrammatic presentation is as below:

* Marine Source: Humpunjabi.com

* Fire Source: SpiderKerala.net



Facultative Reinsurance - It is that type of reinsurance whereby the contract relates to one particular risk and is expressed in the reinsurance policy. This is the oldest method of reinsurance and it necessitates consideration of each risk separately. Each transaction under facultative reinsurance has to be negotiated individually. Each party to the transaction has a free choice, i.e., for the ceding company to offer and the reinsurer to accept. The main drawbacks of this type of insurance are the volume of work involved and time taken to cover the risk. It is, however, still used even today, mainly when:

- (i) automatic covers have already been exhausted.
- (ii) the risk is excluded from the Treaties.
- (iii) the insurer does not want his reinsurance treaties overburdened with particularly heavy and abnormal risks.
- (iv) the insurer has no automatic cover at his disposal in a particular branch, where he issues policies rarely.
- (v) the nature of business is such that technical guidance or consultation with the reinsurer is required at every stage of acceptance of the risk itself or for a type of business where the number of risks is very small, for example, in atomic energy installations, oils rigs, etc.

Treaty Reinsurance - Under this type of reinsurance, a treaty agreement is entered into between the ceding company and the reinsurer(s) where reinsurances are within the limits of the treaty. These limits can be monetary, geographical, section of business, etc. Under this contract, it is obligatory for the reinsurer to accept all risks within the scope this treaty and it is obligatory for the ceding company to cede risks in accordance with the terms of the treaty. In the case of treaty reinsurance contracts, the insurer generally prepares a statement of treaty reinsurances accounts, either on quarterly basis or on half-yearly basis. These statements are sent to the re-insurer for the purpose of reconciliation of claims lodged under the reinsurance contracts, outstanding claims, claims paid and claims paid in advance. It may be noted here that the treaty reinsurance contracts generally provide that in the event of any large claim being

lodged with the insurer, the re-insurer shall make the payment even before the claim is finally settled or the statement of treaty reinsurance is received by the reinsurer. The reinsurer, in such cases, treats the amount paid to the insurer as 'advance against claim'. The Advance against Claim Account is squared up as and when the claim is settled and the information of this settlement is sent to the reinsurer through statement of treaty reinsurances. Such payments by the reinsurer are called Cash Loss Payments. Treaties can also be divided into two categories, viz., proportional treaties and non-proportional treaties.

Proportional Treaties - Such treaties are based on pro-rata apportionment of the sum insured, premium and losses, according to a pre-determined percentage/ratio. These treaties can be further classified as follows:

(a) **Quota share treaty** - Under this treaty, the ceding company binds itself to cede a fix percentage of all policies issued by it under a defined scope of business covered by the agreement. The accounting under this treaty is simpler than any other form of treaties. The advantage to the reinsurer under this treaty is that the reinsurer receives the same proportion of all business of the treaty class defined under the treaty. In other words, there is no selection against him. The advantage to the ceding company under this treaty is that, it cannot vary its retention/line for any particular risk, and therefore, it may have to pay premiums even on small risks which could have been retained by the ceding company itself. The use of this treaty is appropriate when a company commences business at a branch where no relevant data is available.

(b) **Surplus Treaty** - Where a company cedes those amounts which it cannot or does not want to retain for its net account, such type of contract is known as surplus reinsurance treaty. If certain risk is totally retained, no surplus is left to be ceded. Surplus is always determined in multiples of ceding company's retention. A company can arrange more surplus treaties by having, say, second surplus treaty or third surplus treaty, etc. An example is given below:

Sum Assured	₹ 500 lakhs
Line	₹ 5 lakhs
Surplus	₹ 495 lakhs

If first surplus treaty is 10 lines, it would cede ₹ 50 lakhs to the treaty and the balance of ₹ 445 lakhs would have to be ceded to other treaty arrangements.

(c) **Auto-fac Treaty** - Under this treaty, a ceding company may reinsure upto a defined limit after cession of its surplus treaties. It is obligatory for the reinsurer to accept cessions within the purview of the agreement. It, thus, resembles a facultative reinsurance treaty as the acceptance is obligatory and in many instances, the details of the risks are submitted by way of a Bordereaux.

(d) **Pools** - More than one insurer may form a Pool under an agreement whereby its members cede a pre-determined proportion of a particular category of business directly written by them into the Pool. They also share the aggregate premiums and claims in the proportion

and the share of premium ceded by each member. In India, the examples of this system are Indian Market Fire Pool and Hull Pools.

Non-Proportional Treaties - Such treaties are characterised by a distribution of liability between the ceding company and the reinsurer on the basis of losses rather than the sum insured, as is the case in proportional reinsurance. The following are the other characteristics of non-proportional treaties:

- (i) Premium is not calculated on each cession, but on the whole portfolio of the ceding company.
- (ii) The premium rate is predetermined.
- (iii) Cost of reinsurance can vary substantially each year, depending on the premium income, loss ratio and reinsurance market situations.
- (iv) Normally no commission is paid.

Non-Proportional Treaties can be further classified into following categories:

(a) Excess of Loss (XL) Treaties - In this type of treaty, the reinsurer's liability arises only when a claim exceeds a predetermined figure relating to a specific branch of the ceding company's business or to its entire business. The Treaty would provide for maximum liability as well as the amount upto which the ceding company would bear the loss itself, which is called the 'Underlying Limit'. The XL cover can also be arranged for an unlimited amount in excess of the underlying limit.

(b) Excess of loss cover on prevent basis - In this type of cover, in case as a result of one event several risks are effected, the loss under each risk is arrived at separately and the underlying limit is applied to each risk to determine the liability of the insurer. This is also known as 'Working Excess of Loss Cover'.

(c) Excess of loss cover on non-prevent basis- In this type of cover, losses resulting from one event are considered together and aggregate amount of loss is determined and one loss underlying limit is deducted from the aggregate amount of the loss to determine the liability of the excess of loss reinsurer. This type of cover provides protection to an insurer against the numerous losses caused by one or the same event such as cyclone, earthquake, etc. This type of cover is also, therefore, known as 'Catastrophic Covers'.

(d) Stop loss treaties - This is also known as 'Excess of Loss Ratio Cover' and it protects the company from losing more than a specified amount for a given class of business. Normally, the amount is fixed in relation to the ceding company's annual premium income for the class of business and is represented as a percentage. Thus, the reinsurer is liable for the losses which exceed the agreed percentage of loss ratio, until the limit of liability is reached which is expressed in the form of loss ratio. Such a treaty protects the annual results of a company in one branch against negative deviation due to increase in the number and cost of claims/losses.

12.9.2 Verification of Re-insurance Inward

Under regulation 4 of the IRDA (General Insurance Re-insurance) Regulations, 2013, every insurer desirous of writing inward re-insurance business should have a well defined underwriting

policy. The decisions on acceptance of re-insurance should be taken by persons with good knowledge and experience. The insurer is required to file with the Authority, its underwriting policy and any changes therein from time to time. The auditor should apply the following verifications measures for re-insurance inward transactions:

- (i) Re-insurance Inward underwriting should be as per the norms and guidelines prescribed by the Insurance Act, 1938 and IRDA Regulations. It is necessary to ensure that the inward reinsurance arrangements and acceptances, both Indian and foreign are done as per the prescribed parameters applicable for the particular year.
- (ii) The auditor should check that domestic inward acceptances are in accordance with the approved programme.
- (iii) The auditor should verify whether re-insurance inward acceptance, both Indian and foreign, are as per arrangements / agreements entered into with Indian and foreign insurance companies.
- (iv) The auditor should also verify whether the policy adopted for booking the accounts is on "receipt" basis or "due" basis with the appropriate basis of estimation towards accounts not received and that the basis of estimation is fair and consistently applied and properly disclosed.
- (v) The auditor should examine whether proper system exists to have control over the quantum of agreements existing at any point of time and also that periodical accounting statements received in connection with the agreements.
- (vi) The auditor should verify whether proper closing returns have been received for premiums and claims for facultative acceptances.
- (vii) The auditor should check the accounts for closure of any underwriting year, with portfolio withdrawals as per the terms and conditions agreed.
- (viii) The auditor should evaluate the system and practice adopted in recognising the foreign currency transaction and also whether it is in accordance with the Accounting Standard - 11 "The Effects of Changes in Foreign Exchange Rates".
- (ix) The auditor should verify whether profit commission has been calculated as per the agreement and terms and conditions and all the statements rendered are properly taken into account.
- (x) The auditor should check whether there is any run off claim / large claim of long chain in nature which requires any provisioning.
- (xi) The auditor should also verify whether the Foreign Inward acceptance components, consisting of premium, commission, brokerage and other expenses, claims consisting of paid claims opening and closing outstanding claims etc., have been recorded and accounted as per the accounts rendered by the companies. It is essential that the statement should be rendered in the currency in which it was agreed to be transacted and the conversion of foreign currency balances from the accounts submitted have been done at the appropriate conversion rates as per Accounting Standard -11.

12.30 Advanced Auditing and Professional Ethics

- (xii) The auditor should examine whether the outstanding claim figures have been properly obtained well in time, under proper systematic arrangements and sufficient provisioning has been made for all the outstanding claims. The auditor should see that regarding foreign inward, appropriate provisioning is done after adopting prescribed conversion rate to the Indian rupee. The auditor should ensure that confirmation regarding the outstanding claims have been received in respect of all inward arrangements.
- (xiii) As per IRDA (General Insurance Re-insurance) Regulations, 2013, every re-insurer is required to make provision for outstanding claims for every reinsurance arrangement accepted on the basis of loss information advices received from brokers /cedants and where such advices have not been received, on an actuarial estimation basis. In addition, every re-insurer has to make an appropriate provision for 'Incurred but Not Reported (IBNR)' claims on its reinsurance accepted portfolio on actuarial estimation basis. This aspect has to be looked into as this may result in a lot of difference in the financial results of the company.
- (xiv) Closing balances of the re-insurer's accounts should be reconciled and the confirmation of balances should be obtained from all the companies.
- (xv) The auditor must ensure that foreign inward accounts balances have been re-stated at the prevailing value at the year end and that difference arising out of re-statement has been taken to Profit and Loss Account.
- (xvi) The auditor should verify the requirement of provision / writing off of reinsurance inward balances based on the doubtful nature of recovery, if any.
- (xvii) The auditor should check whether Indian inward balances including with the GIC have reconciled and identical balances arrived at and affect, if any, due to co-insurance transactions should also be looked into.

12.9.3 Verification of Re-insurance Outward

The following steps may be taken by the auditor in the verification of re-insurance outward:

- (i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.
- (ii) The auditor should check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
- (iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- (iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.
- (v) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.
- (vi) It should also be seen whether the commission on cession has been calculated as per the terms of the agreement with the re-insurers.

- (vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
- (ix) The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.
- (x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.
- (xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- (xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- (xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledger balances tallies with the general ledger balances.
- (xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning / write off or write back.
- (xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
- (xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-a-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.
- (xvii) Any major event after the Balance Sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

12.10 Co-Insurance

Where the insured chooses to have more than one insurer for the same transaction of risk, it would amount to coinsurance. The concept of co-insurance emerges, when there is a predetermined set of understandings, leader of the business receives the premium and issues policy with a co-insurance clause in the policy and the referred leader also settle the claims to the insured in case of the occurrence of claims. Balances pertaining to other companies relating to premiums and claims are accounted under co-insurance as "Amounts due to / due from" other insurance companies.

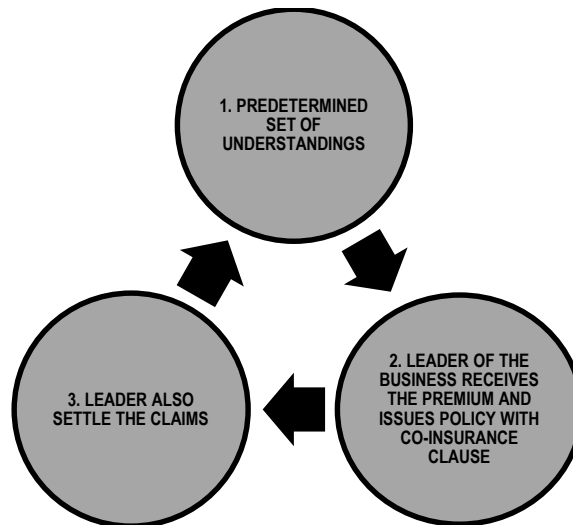


Diagram presenting the concept of Co-insurance

Balances are settled in periodical meetings and exchange of statements as agreed between the companies. Suitable slot can be provided in the systems to incorporate co-insurance requirements. Most of the practice in accounting and settlement of co-insurance transactions are industry specific and insured specific. Hence, system may suitably be designed to accommodate all the possibilities of co-insurance accounting and settlements.

The auditors should get information from the agreement arrived at the Insurance Council, where the insurance companies may chose to be the members. (Wherever the concept of Insurance Council is in place). Members of the Insurance Council could arrive the mutually agreeable terms and norms of entering into coinsurance agreement and the norms for settlement of dues. The Insurance Council may recommend the following norms while entering into coinsurance agreement:

- ◆ Settlement of commission Collection and Remittance of service tax
- ◆ Standard practices for settlement of dues
- ◆ Settlement of claims
- ◆ Reinsurance arrangement for the risk booked
- ◆ Exceptional booking and the powers thereof deviating from the Council's understanding .

The auditor should go through the understanding of the Council and ensure that the risks are covered as per the terms and conditions with adequate consideration and proper settlement.

12.11 Solvency Margin

Section 64VA of the Insurance Act, 1938 as amended by Insurance Laws (Amendment) Act, 2015 requires every insurer and re-insurer to maintain an excess of the value of assets over the amount of liabilities at all times which shall not be less than 50% of the amount of minimum

capital as stated under section 6 (requirement as to capital) of the Act and arrived at in the manner specified by the regulations.

The Authority, by way of regulation, shall specify a level of solvency margin known as 'control level of solvency'. However, in certain special circumstances, the authority may direct application of this provision with some modifications provided this shall not result in the control level of solvency being less than what is stipulated in above para.

If, at any time, an insurer or re-insurer does not maintain the required control level of solvency margin, he is required to submit a financial plan to the Authority indicating the plan of action to correct the deficiency. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money. Sub-section (2) of section 64VA states that if an insurer or re-insurer fails to comply with the prescribed requirement of maintaining excess of value of assets over amount of liabilities, it shall be deemed to be insolvent and may be wound up by the Court on an application made by the authority.

12.11.1 IRDA Regulations

The Insurance Act requires every insurer to furnish a statement of his assets and liabilities as assessed in the manner laid down by the section 64V.

Every Insurer is required to prepare a statement of value of assets in "Form IRDA-Assets-AA." A statement of the amount of liabilities in case of general insurance business is to be prepared in "Form HG" and a statement of Solvency Margin in "Form KG" as specified in the Insurance Regulatory and Development Authority (Assets, Liabilities and Solvency Margin of Insurers) Regulations, 2000. The statement of assets, liabilities and solvency margin are to be certified by an auditor and filed by the insurance company with the Authority along with the audited accounts and statements.

12.12 Trade Credit Insurance

"Trade Credit Insurance business" means the business of effecting contracts of insurance in respect of trade credit insurance transactions.

"Trade credit insurance" means insurance of suppliers against the risk of non-payment of goods or services by their buyers who may be situated in the same country as the supplier (domestic risk) or a buyer situated in another country (export risk) against non-payment as a result of insolvency of the buyer or non-payment after an agreed number of months after due-date (protracted default) or non-payment following an event outside the control of the buyer or the seller (political risk cover). Political risk cover is available only in case of buyers outside India and in countries agreed upon at the proposal stage.

"Trade Credit Insurance transaction" means a transaction between two persons for supply of goods or services on open and agreed terms.

12.34 Advanced Auditing and Professional Ethics

"Trade Credit insurance policy" is a conditional insurance contract between two parties (insurer and seller) that cannot be traded and is always directly related to an underlying trade transaction, which is either the delivery of goods or of services. The correct fulfilment of this trade transaction and satisfaction of the contract terms is essential for credit cover to exist.

12.12.1 Basic Requirements of a Trade Credit Insurance Product

An insurer shall offer trade credit insurance product only if all requirements mentioned below are met -

- (i) Policyholder's loss is non-receipt of trade receivable arising out of a trade of goods or services.
- (ii) Policyholder is a supplier of goods or services in consideration for a fair market value.
- (iii) Policyholder's trade receivable does not arise out of factoring or reverse factoring arrangement or any other similar arrangement.
- (iv) Policyholder has a customer (*i.e.* Buyer) who is liable to pay a trade receivable to the policyholder in return for the goods and services received by him from the policyholder, in accordance with a policy document filed with the insurer.
- (v) Policyholder undertakes to pay premium for the entire Policy Period.
- (vi) Any other requirement that may be specified by the Authority from time to time.

Audit of Co-Operative Societies

13.1 Introduction

The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts. An auditor of a co-operative society should be familiar with the provisions of the particular Act governing the society under audit.

Co-operative society is a business organisation with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.

A chartered accountant has to play a significant role in the development of co-operative organisations on scientific lines. In this Unit, it is proposed to give a few guidelines in the matter of audits of co-operative societies.

Apart from audit, some other professional services could be rendered by chartered accountants such as-

- (1) guidance in accounts writing,
- (2) installation of accounting system,
- (3) internal audit,
- (4) management accounting services,
- (5) taxation etc.

However, the main focus is to give some guidelines about the audit of co-operative societies in general. The special features of audit applicable to all societies will be considered first, and subsequently a few special points with reference to audit programmes of specific types of societies will be considered.

13.1.1 Audit as per Section 17 of the Co-Operative Societies Act, 1912

- (1) The Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year.
- (2) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.

13.2 Advanced Auditing and Professional Ethics

- (3) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of the society as the person making such inspection may require.

"Registrar" means a person appointed to perform the duties of a Registrar of Co-operative Societies under this Act.

13.2 Auditor and Management

According to the nature of particular co-operative society the auditor will have to examine in general the pattern of management, delegation of authority and fixation of responsibilities. The examination of minute books will reveal important policy decisions taken by management. The Board of Directors is the chief executive body and the minute book recording the minutes of its meetings is the main evidence for an auditor to go through the entity's management decisions. The auditor should see how far these decisions are in line with co-operative principles, interest of members, the provisions in the respective co-operative law of the State applicable to the society; and lastly the provisions of bye-laws of the society. The Central Co-operative Societies Act, 1912 does not contain any direct provisions relating to the management and meetings. As such for the sake of guidance and reliance, regard shall be had to the respective Co-operative Societies Act. For instance, according to section 72 of Maharashtra State Co-operative Societies Act, 1960, the management of every society shall vest in a Committee constituted in accordance with the Act and rules and bye-laws. The managing committee elects a chairman, who is in charge of general administration; other administrative officers are Managing Director, Manager or Secretary according to the nature of the society. The administrative functions of a managing committee include the following:

- (1) Proper custody and maintenance of movable and immovable properties belonging to the society.
- (2) Proper maintenance of accounts relating to receipts and payments of the society, through its accounting staff.
- (3) To summon and attend all the meetings including Annual General Meeting and to record the proceedings of the meetings in a proper minute book.
- (4) To keep all the necessary registers and records required by the Co-operative Societies Act and Rules and bye-laws of the society.

Generally in case of co-operative organisations the management is not manned by professional managers and as such the auditor of a co-operative society could play a constructive role in the capacity as a guide, friend and an adviser to the society. The auditor should see that the actions of managing committee are not inconsistent with the resolutions passed by the meetings of general body and managing committee, provisions of Co-operative Societies Act and rules and bye-laws of the society.

The following points should be kept in mind in connection with the audit of a co-operative society:

1. Qualifications of Auditors - Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

2. Appointment of the Auditor - An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

3. Books, Accounts and other records of Co-operative Societies - Under section 43(h) of the Central Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society.

For example, in Maharashtra, the co-operative societies are required to maintain books of account in terms of the instructions of the Registrar as following:

- (i) All sums of money received and expended by the society and the matters in respect of which receipts and expenditure take place.
- (ii) All sales and purchases of goods by the society.
- (iii) Assets and liabilities of the society.

In order to maintain proper financial accounting records so as to disclose full financial results of working of the society, the statutory or mandatory provisions provide a directive, but they are not conclusive. The society is at liberty to maintain such additional records according to its convenience and which it thinks more useful for clarity and detailed explanation. Ultimately the financial transactions and the results thereof must be presented very clearly and in the best possible manner.

Depending upon the nature and object of the society, different kinds of books and registers will be maintained, so as to disclose a proper and fair picture of financial transactions. In case of large scale co-operative organisation, different subsidiary books and registers shall be maintained and the daily summary totals will be transferred to main Cash Book. For example:

- (a) Daily cash sales summary register.
- (b) A register of collection from debtors if credit sales are allowed by bye-laws of society.
- (c) A register of recovery of loans from salaries and directly by receipts from members in case of credit society.
- (d) Loan disbursement register in case of credit society.
- (e) Any other columnar subsidiaries depending upon the nature and functions of society.

4. Restrictions on share holdings - According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

5. Restrictions on loans - Section 29 of the Central Act puts restriction on loan. It states that a registered society shall not make a loan to any person other than a member. However, with the special sanction of the Registrar, a registered society may make a loan to another registered society.

The State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

6. Restrictions on borrowings - Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect.

7. Investment of funds - According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:

- (a) In the Central or State Co-operative Bank.
- (b) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
- (c) In the shares, securities, bonds or debentures of any other society with limited liability.
- (d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
- (e) In any other moneys permitted by the Central or State Government.

In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

8. Appropriation of profits - According to section 33 of the Central Act, a prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

9. Contributions to Charitable Purposes - According to section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

10. Investment of Reserve Fund outside the business or utilisation as working capital -

Some of the State Acts provide that a society may use the Reserve Fund:

- (a) in the business of a society, as working capital (subject to the rules made in this behalf).
- (b) may invest as per provisions of the Act.
- (c) may be used for some public purposes likely to promote the object of the society.

The auditor should ensure strict compliance with the State Act and Rules in this regard.

11. Contribution to Education Fund - Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Contribution to Education Fund is a charge on profits and not an appropriation.

Apart from statutory provisions relating to Reserve Fund, the auditor may have regard to the provisions in bye-laws and Rules and Regulations of the society regarding the appropriation of profits. Transfers to other reserves, dividends to members etc. are the other appropriations. Appropriations of profits must be approved by the General Body of the society, which is the supreme authority in the co-operative management. Further, it may be noted that necessary accounting entries for the appropriation of profits must be passed after the date of approval by the General Body. Here there is a departure from corporate accounting practice, where entries are passed for proposed appropriations, subject to approval of Annual General Meeting.

According to certain State Acts, transfers to Dividend Equalization Reserve and Share Capital Redemption Fund are stated as charges against profits. According to the generally accepted principles of accountancy these items are not charges, but appropriation of profits. The auditor should point out such spots where statutory provisions of any law are in contradiction with the generally accepted accounting principles.

13.3 Special Features of Co-Operative Audit

The general processes of auditing involved in audit work such as checking of posting, ascertainment of arithmetical accuracy, vouching, verification of assets and liabilities and final scrutiny of Balance Sheet are well known to the students, and the same are to be applied in co-operative audit as well. It need not be discussed in detail.

However, the special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:



1. Examination of overdue debts - Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.

2. Overdue Interest - Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

3. Certification of Bad Debts - A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per the said rules, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.

4. Valuation of Assets and Liabilities - Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the

acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions. The current assets be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

5. Adherence to Co-operative Principles - The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be affected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

6. Observations of the Provisions of the Act and Rules - An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

7. Verification of Members' Register and examination of their pass books - Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation. Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part. Of course this checking will be resorted to on a test basis, which is a matter of judgement of the auditor.

8. Special report to the Registrar - During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance, a special report may become necessary:

- (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
- (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

13.8 Advanced Auditing and Professional Ethics

- (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
- (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

9. Audit classification of society - After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

10. Discussion of draft audit report with managing committee - On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

13.4 Rights and Duties of Co-Operative Auditors

Section 17 of the Co-operative Societies Act, 1912 contains audit provision as under:

- (i) The Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year.
- (ii) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.
- (iii) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of the society as the person making such inspection may require.

On completion of audit, the auditor has to submit his audit report to the society, and copies thereof to the respective authorities such as District Special Auditor, District Deputy Registrar etc. The audit report has to be submitted in the prescribed form specified by the Registrar or as given in the related Rules. According to the present prescribed form in some of the States, the auditor has to state:

- (a) Whether he has obtained all the necessary information and explanations which to the best of his knowledge and belief were necessary for the purpose of audit.

- (b) Whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give all the information required by the Act.
- (c) Whether the Profit and Loss Account of the society gives a true and fair view of the Profit and Loss made by the society.
- (d) Whether the Balance Sheet drawn up as at the end of the year gives a true and fair view of the state of affairs of the society as on the given date.
- (e) Whether in his opinion, proper books of account as required by the Act, the Rules and the bye-laws of the society have been properly maintained.
- (f) Whether the Balance Sheet and the Profit and Loss Account examined by him are in agreement with the books of account and returns of the society.

The auditor will have to give qualifying observations, if any of the answers to the above mentioned matters are negative.

13.5 Form of Audit Report

The form of the audit report to be submitted by the auditor, as prescribed in various states, contains a number of matters which the auditor has to state or comment upon. For example, the Rules formed under the Maharashtra State Co-operative Societies Act requires the auditor to make the usual affirmation pertaining to proper maintenance of books of accounts, true and fair nature of financial statements, etc. In addition to the above, the auditor will have to attach schedules to the report regarding the following information:

- (1) All transactions which appear to be contrary to the provisions of the Act, the rules and bye-laws of the society.
- (2) All sums, which ought to have been, but have not been brought into account by the society.
- (3) Any material, or property belonging to society which appears to the auditor to be bad or doubtful of recovery.
- (4) Any material irregularity or impropriety in expenditure or in the realisation or monies due to society.
- (5) Any other matters specified by the Registrar in this behalf.

In the case of Nil report in any of the above matters, the auditor will have to give a Nil report.

Further in addition to the audit certificate in the prescribed form and various schedules stated above, the auditor of co-operative society in the applicable State has to answer two sets of questionnaires called as audit memos. The first set of audit memo or questionnaire is of general nature and is applicable to all types of societies such as urban banks, consumers' stores, credit societies etc. The second set of questionnaire is specific for a particular type of society. These questionnaires are drafted in detail and serve the practical purpose of audit programme.

The audit report in a narrative form is also required to be submitted by the auditor addressed to

13.10 Advanced Auditing and Professional Ethics

the Chairman of the society. Generally the narrative audit report as per convention is divided into two parts styled as part I and part II. Part I of the report is very important which throws a light on comparative financial position, capital structure, solvency position and the profitability or otherwise of the society. It may contain comments on the working of the society and the suggestions for future improvements. It must be suitably divided into paragraphs. Part II of the report points out the observations of routine nature, which are the finished products of the routine vouch and post audit such as missing vouchers, loan bonds, inadequacies of documents, mistakes of principles in accounting etc. However mistakes having an impact on the profitability of society should be pointed out in Part I as it has got a consequential effect on the financial position of society.

13.6 Audit, Inquiry and Inspection of Multi-State Co-Operative Societies

The Multi-State Co-operative Societies Act, 2002, which came into force in August, 2002 applies to co-operative societies whose objects are not confined to one State. The Act contains detailed provisions regarding registration, membership and management of such societies.

The funds of a Multi-State co-operative society cannot be utilised for any political purpose. The Act contains detailed provisions regarding the investment of funds and restrictions on loans, borrowings, etc.

Books of Accounts - As per Multi-State Co-operative Society Rules 2002, every Multi-State Co-operative society shall keep books of account with respect to-

- a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place;
- b. all sale and purchase of goods;
- c. the assets and liabilities;
- d. in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-hours of such a society.

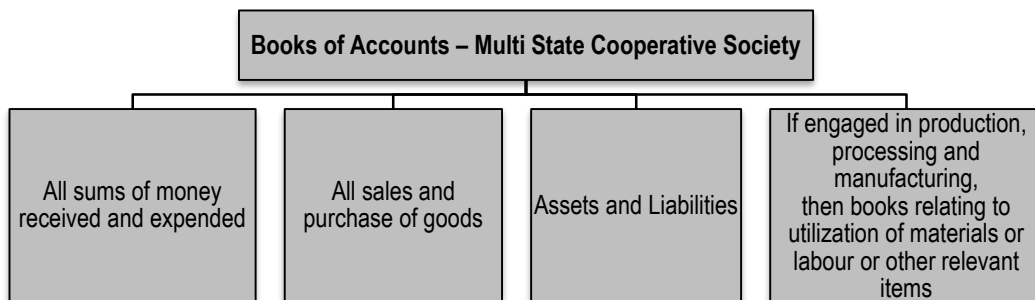


Diagram showing the Books of Accounts to be maintained by Multi State Co-operative Society

13.6.1 Audit of Multi-State Co-operative Society –

1. Qualification of Auditors - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However the following persons are not eligible for appointed as auditors of a Multi-State co-operative society-

- (a) A body corporate.
- (b) An officer or employee of the Multi-State co-operative society.
- (c) A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.
- (d) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

2. Appointment of Auditors - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

3. Power and duties of Auditors – Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi-State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiry:

- (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,
- (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,

13.12 Advanced Auditing and Professional Ethics

- (c) Whether personal expenses have been charged to revenue account, and
- (d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

4. Content of Auditor's Report - As per sub-section (3) & (4) of section 73 of Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year.

The auditor's report shall also state:

- (a) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
- (b) Whether, in his opinion, proper books of account have been kept by the Multi-State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.
- (c) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
- (d) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

5. Power of Central Government to direct special audit in certain cases - Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

- (a) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual aid and co-operative principles or prudent commercial practices or with sound business principles; or

- (b) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- (c) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

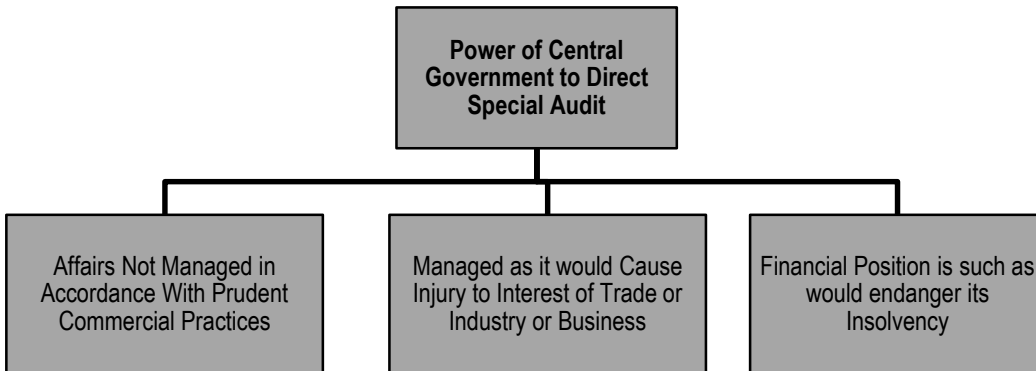


Diagram showing Power of Central Government to Direct Special Audit

The central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order, shall be conducted and appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

However, central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society.

The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a Multi-State co-operative society has under section 73. However the special auditor shall instead of making his report to the members of the Multi-State co-operative society make the report to the Central Government. The report of the special auditor shall, include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.

On receipts of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force.

However, if the Central Government does not take any action on the report within four months from the date of its receipt, that Government shall send to the Multi-State Co-operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

The expenses of, and incidental to, any special audit under this section (including the

13.14 Advanced Auditing and Professional Ethics

remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.

13.6.2 Inquiry by Central Registrar under Section 78

The Central Registrar may, on a request from a federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or not less than one-third of the members of the board or not less than one-fifth of the total number of members of a Multi-state co-operative society, hold an inquiry or direct some person authorized by him by order in writing in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society. However, before holding such inquiry fifteen days notice must be given to the Multi-State co-operative society.

The Central Registrar or the person authorized by him shall have the following powers, namely:

- (a) he shall at all reasonable times have free access to the books, accounts, documents, securities, cash and other properties belonging to or in the custody of the Multi-State co-operative society and may summon any person in possession or responsible for the custody of any such books, accounts, documents securities, cash or other properties to produce the same at any place specified by him.
- (b) he may, notwithstanding any bye-law specifying the period of notice for a general meeting of the Multi-State co-operative society, require the officers of the society to call a general meeting of the society by giving notice of not less than seven days at such time and place at the head quarters of the society to consider such matters as may be directed to him, and where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.
- (c) he may summon any person who is reasonably believed by him to have any knowledge of the affairs of the Multi-State co-operative society to appear before him at any place at the headquarters of the society or any branch thereof and may examine such person on oath.

The Central Registrar shall, within a period of three months of the date of receipt of the report, communicate the report of inquiry to the Multi-State co-operative society, the financial institutions, if any, to which the society is affiliated, and to the person or authority, if any at whose instance the inquiry is needed.

13.6.3 Inspection of Multi-State Co-operative societies under Section 79

The Central Registrar may, on a request from federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or not less than one-third of the members of the board or not less than one-fifth of the total number of members of a Multi-State co-operative society by general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society.

However, no inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.

The Central Registrar or the person authorized by him shall have the following powers:

(a) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.

(b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

Audit of Non-Banking Financial Companies

14.1 Introduction

Non-Banking Finance Company sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into new areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system. There is therefore, a felt need to address the risks, without impeding the dynamism displayed by NBFCs in delivering innovation and last mile connectivity for meeting the credit needs of the productive sectors of the economy.



Fig. : NBFCs*



Fig.: Audit of NBFCs*

Further, the RBI (Amendment) Act, 1997 provides for compulsory registration with the Reserve Bank of all NBFCs, irrespective of their holding of public deposits, for commencing and carrying on business, minimum entry point norms, maintenance of a portion of deposits in liquid assets, creation of Reserve Fund and transfer of 20 per cent of profit after tax annually

* Source: *Techno Legal Journalists*

* Source: *Inventicon*

to the Fund. The Amendment Act also conferred powers on Reserve Bank to issue directions to companies and its auditors, prohibit deposit acceptance and alienation of assets by companies and effect winding up of companies.

Accordingly, the Reserve Bank issued directions to companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of directors and shareholders.

Definition of NBFC

Section 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

- (i) A financial institution which is a company;
- (ii) A non banking institution which is a company with principal business of receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- (iii) Such other non-banking institution or class of such institutions, as the Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a –“Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company”.



Fig. : What is NBFC*

* Source: Slideshare

Registration and Regulation of NBFC

Under Section 45–IA of the Reserve Bank of India (Amendment) Act, 1997, no non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

A company incorporated under the Companies Act, 2013 and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

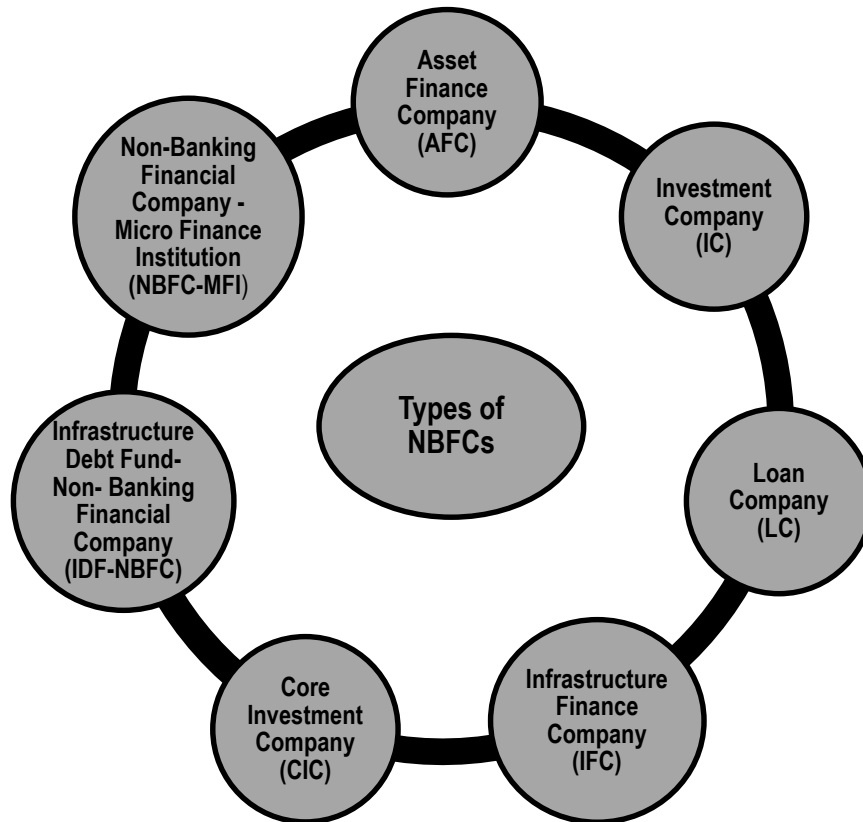
However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 406 of the Companies Act, 2013, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

Type of NBFCs- Compliance and Regulatory Perspective

Non-Banking Financial Company - In terms of the Section 45-I(f) read with Section 45-I (c) of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. Consequent upon to RBI Circular December 6, 2006, companies financing real/physical assets for productive/ economic activity will be classified as Asset Finance Company (AFC) as per the specified criteria. The remaining companies would be continued to be classified as loan/investment companies/Infrastructure Finance Company. In the proposed structure the following categories of NBFCs will emerge:

Currently, NBFCs registered with RBI are being classified as:



[Note: Student may refer detailed description of types of NBFCs, given in CA. Final Paper 1: Financial Reporting Study Material.]

14.2 Audit Procedure

The following are the necessary steps involved -

(1) **Ascertaining the Business of the company** - The first step in carrying out the audit of a NBFC is to scan through the Memorandum and Articles of Association of the company, so as to acquaint oneself with the type of business that the company proposes to engage itself in. Normally, the Memorandum of Association of any company would be very wide in scope thereby permitting it to undertake a host of business activities, but companies generally tend to specialise in and focus on a few select activities. An auditor should therefore make a careful study of the business policy of the company so as to ascertain its principal business activities. For this purpose, an auditor may also scan through the minutes of the Board/Committee Meetings and hold discussions with the top level management to ascertain the corporate business plan/strategy which would give him a clear picture as to the principal objects of the company. An auditor should then independently corroborate his findings with the actual business done by the company, as reflected by the company's financial results.

14.5 Advanced Auditing and Professional Ethics

The task of ascertaining the principal business activity of any NBFC is of paramount importance (More so with the recent amendments made to the RBI Act) since the very classification of a company as a NBFC and its further classification into a loan company or an investment company or an equipment leasing/hire purchase finance company would all depend upon its principal business activity. Based on the classification of a company into a loan Company/Investment company etc., it will be accordingly required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

(2) Evaluation of Internal Control System - The responsibility of maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision making. An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at its very inception which would ultimately result in the NBFC having an alarmingly high level of NPAs.

(3) Registration with the RBI - Section 45-IA inserted by the RBI Act, w.e.f. 9th January, 1997, has made it incumbent on the part of all NBFCs to comply with registration requirements and have minimum net owned funds (NOF) of ₹ 2 Crore (Although the requirement of minimum NOF at present stands at ₹ 200 lakh, the minimum NOF for companies that were already in existence before April 21, 1999 was retained at ₹ 25 lakh. However, for strengthening the financial sector and technology adoption, and in view of the increasing complexities of services offered by NBFCs, it shall be mandatory for all NBFCs to raise minimum NOF to ₹ 1 crore by March, 2016, and to further double it to ₹ 2 crore by 2017) for commencing/carrying on its business. An auditor should obtain a copy of the certificate of registration granted by the RBI or in case the certificate of registration has not been granted, a copy of the application form filed with the RBI for registration. It may particularly be noted that NBFCs incorporated after 9th January, 1997 are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should therefore verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC. Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are NBFCs but they have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

Every NBFC holding public deposits is required to invest a specified percentage (as the RBI may specify from time to time). The RBI has also prescribed a format for reporting to ensure compliance with the requirement of maintenance of liquid assets on a quarterly basis. This quarterly return (duly signed by an officer of the NBFC) is required to be submitted within 30 days from the end of the relevant quarter and with reference to investments held in approved securities during the relevant quarter. The auditor should ascertain whether investment in prescribed liquid assets have been made and whether quarterly returns as mentioned above have been regularly filed with the RBI by the concerned NBFC.

(4) NBFC Public Deposit Directions - The auditors must ascertain whether the company is a loan company or an investment company or a hire purchase finance company or an equipment leasing company as per the classification, if any, assigned to the NBFC by the RBI. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results. Thereafter, it must be ascertained whether the company has complied with the following aspects in relation to the activity of mobilisation of public deposits:

- (i) The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.

In the event of a downgrading of credit rating, the auditor should bear in mind that the NBFC will have to reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame.

- (ii) Test checks the interest calculations in respect of public deposits mobilised by a NBFC to ascertain that the NBFC has not paid interest in excess as per specification. Likewise, test check the brokerage calculations with the bills and vouchers for reimbursement of out of pocket expenses submitted by a broker to ascertain that the NBFC has not paid brokerage in excess by way of reimbursement of expenses to brokers.
- (iii) Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application form the depositor in the form to be supplied by the company, and shall contain all particulars specified in the Non-Banking Financial Companies and Miscellaneous Non Banking Companies (Advertisement) Rules, 1977. Further ensure whether it contain the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.
- (iv) Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. Also check whether the NBFC is regularly paying its deposits on due dates and in the case of a delay/default, the reasons for the delay/default and the actual date of payment.

14.7 Advanced Auditing and Professional Ethics

- (v) Check whether the investments made in approved liquid assets by a NBFC holding public deposits have been lodged in safe custody with a designated scheduled commercial bank as required by the NBFC Public Deposit Directions. Obtain a certificate from the bank to that effect.
- (vi) In the case of NBFCs accepting/holding public deposits ascertain whether audited statement of accounts together with a copy of the auditor's report and director's report thereon have been submitted within prescribed time limit from the date of holding the Annual general meeting.
- (vii) Check whether the NBFC has filed its annual return as specified in the First Schedule before the 30th June with reference to its position as on the 31st March of each year.
- (viii) In the case of NBFCs not accepting/holding public deposits, check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.
- (ix) In the case of Group Holding Investment Companies, check whether the NBFC has passed a board resolution to the effect that the company has invested or would invest/hold its investments in share and securities of group companies specifying the names of the companies. In addition to the above, group holding investment companies are required to give a further undertaking that it would not trade in such shares/securities and that it has neither accepted nor would it accept any public deposits during the year.

(5) NBFC Prudential Norms Directions -

- (i) Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.
- (ii) An auditor should ensure that the Board of Directors of every NBFC granting/intending to grant demand/call loans shall frame a policy for the company and shall implement too.
- (iii) An auditor should assess on the basis of examinations conducted by him whether the NBFC has complied with the prudential norms. In particular, he should verify that advances and other credit facilities have been properly classified as standard/sub standard/doubtful/loss and that proper provision has been made in accordance with the Directions.
- (iv) In respect of Non Performing Assets, an auditor should check whether the unrealised income in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.
- (v) Check whether all accounts which have been classified as NPAs in the previous year also continue to be shown as such in the current year also. If the same is not treated as a NPA in the current year, the auditor should specifically examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the Directions.

14.3 Classification of Frauds by NBFC (RBI Circular July, 2015)

In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:

- (a) Misappropriation and criminal breach of trust.
- (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- (c) Unauthorised credit facilities extended for reward or for illegal gratification.
- (d) Negligence and cash shortages.
- (e) Cheating and forgery.
- (f) Irregularities in foreign exchange transactions.
- (g) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat/ defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

- (a) cases of cash shortages more than ₹ 10,000/- and
- (b) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

14.4 Audit Check-List

Some special points that may be covered in the audit of NBFCs are given below:

A. Investment Companies

- (i) Physically verify all the shares and securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.
- (ii) NBFC Prudential Norms stipulates that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.

14.9 Advanced Auditing and Professional Ethics

- (iii) Verify whether the NBFC has not advanced any loans against the security of its own shares.
- (iv) Verify that dividend income wherever declared by a company, has been duly received by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General meeting and its right receives the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.
- (v) Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.
- (vi) Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.
- (vii) Check whether the investments have been valued in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.
- (viii) Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- (ix) Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.
- (x) An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
- (xi) In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.
- (xii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities and provision for the return including pre-mature return of the securities deposited/lent.
- (xiii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).

- (xiv) Verify charges received or paid in respect of securities lend/borrowed.
- (xv) Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

B. Loan Company

- (i) An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.
- (ii) An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.
- (iii) Obtain balance confirmations from the concerned parties.
- (iv) As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.
- (v) Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.
- (vi) Check whether the NBFC has not advanced any loans against the security of its own shares.
- (vii) In case of companies which are engaged in the business of providing short term funds in the ICD market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the credit worthiness of the clients prior to placed by the company are being rolled over and whether there is any risk of non-recovery. In addition, he should ascertain that the NBFC is receiving interest regularly in respect of these ICDs. Roll over of ICDs and non-realisation of interest and principal amounts should be thoroughly checked to determine whether the ICD is required to be treated as a NPA.
- (viii) An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
- (ix) Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, doubtful assets and loss assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.
- (x) An auditor should also verify whether provision for bad and doubtful debts has been disclosed separately in the Balance Sheet and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.

C. Asset Finance Company

1. Hire Purchase Finance Company

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.
- (ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.
- (iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.
- (iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.
- (v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.
- (vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.
- (vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.
- (viii) Verify that the assets given on hire purchase have been adequately insured against.
- (ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

2. Equipment Leasing Finance Company

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.
- (ii) The auditor should verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In respect of some major transactions, an auditor should arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.

- (iii) Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets is being carried out by the lessee.
- (iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.
- (v) An auditor should verify whether the AS issued by the Institute of Chartered Accountants of India in respect of "Accounting for Lease" has been compulsorily followed.

14.5 Auditor's Duty

The following are the important duties of an auditor -

14.5.1 Compliance with NBFC Auditors Report RBI Directions - The recent RBI regulations have considerably increased the responsibility of auditors of NBFCs. A very onerous task of reporting to the Board of Directors on certain specified matters and to the RBI on an exception basis has been imposed upon him. This reporting requirement is in addition to the normal reporting requirements to the shareholders under section 143 of the Companies Act, 2013. Auditors will thus have to be very careful whilst carrying out audits of NBFCs to ensure that all matters which they are required to take into consideration for the purposes of reporting to the RBI have been taken due care of.

Section 45MA of the Reserve Bank of India Act has been introduced with effect from 13.12.1974. Under this provision the auditor of a non-banking financial company or a non-banking miscellaneous company which has accepted public deposits, has to inquire whether or not the company has furnished to the Reserve Bank of India statements, information of particulars relating to the deposits as are required to be furnished under Chapter IIIB of the Reserve Bank of India Act. The provision further states that if on inquiry the auditor is not satisfied about the compliance by the company, it is his duty to make to the Reserve Bank giving the aggregate amount of deposits held by the company. The auditor is also required to incorporate the report or intended to be made to the Reserve Bank in his report to the company under Section 143 of the Companies Act, 2013. Report to Board of Directors under RBI Directions as per Notification No. DNBS.201 /DG(VL)-2008 dated September 18, 2008, in exercise of the powers conferred by sub-section (1A) of Section 45MA of the Reserve Bank of India Act, 1934 (Act 2 of 1934) and of all the powers enabling it in this behalf, and in supersession of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998, issues to every auditor of every non-banking financial company, the Directions hereinafter specified.

1. Short title, application and commencement of the Directions

- (i) These Directions shall be known as "Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008."

14.13 Advanced Auditing and Professional Ethics

(ii) These Directions shall apply to every auditor of a non-banking financial company as defined in Section 45 I(f) of the Reserve Bank of India Act, 1934 (2 of 1934) hereinafter referred to as non-banking financial company.

(iii) These Directions shall come into force with immediate effect.

2. Auditors to submit additional Report to the Board of Directors: In addition to the Report made by the auditor under Section 227 of the Companies Act, 1956 (1 of 1956) [now Section 143 of the Companies Act, 2013] on the accounts of a non-banking financial company examined for every financial year ending on any day on or after the commencement of these Directions, the auditor shall also make a separate report to the Board of Directors of the Company on the matters specified in paragraphs 3 and 4 below.

3. Matters to be included in the auditor's report: The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely:

(A) In the case of all non-banking financial companies

- I. Whether the company is engaged in the business of non-banking financial institution and whether it has obtained a Certificate of Registration (CoR) from the Bank.
- II. In the case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31 of the applicable year.

(B) In the case of a non-banking financial company accepting/holding public deposits: Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

- (i) Whether the public deposits accepted by the company together with other borrowings indicated below viz;
 - (a) from public by issue of unsecured non-convertible debentures/bonds;
 - (b) from its shareholders (if it is a public limited company); and
 - (c) which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;
- (ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are regularised in the manner provided in the said Directions;
- (iii) Whether an Asset Finance Company having Capital to Risk Assets Ratio (CRAR) less than 15% or an Investment Company or a Loan Company as defined in paragraph 2(1)(ia), (vi) and (viii) respectively of Non-Banking Financial Companies Acceptance of

Public Deposits (Reserve Bank) Directions, 1998 is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency;

- (iv) In respect of NBFCs referred to in clause (iii) above,
 - (a) whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 is in force; and
 - (b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;
- (v) In case of NBFCs having Net Owned Funds of ₹ 25 lakh and above but less than ₹ 200 lakhs, whether the public deposit held by the companies is in excess of the quantum of such deposit permissible to it in terms of Notification No. DNBS. 199/CGM (PK) - 2008 dated June 17, 2008 and whether such company:
 - (a) has frozen its level of deposits as on the date of that Notification; or
 - (b) has brought down its level of deposits to the level of revised ceiling of deposits in terms of that Notification.
- (vi) Whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;
- (vii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Reserve Bank of India in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- (viii) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;
- (ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the Bank in terms of Notification No.DNBS.172/CGM(OPA)-2003 Dated July 31, 2003;
- (x) Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;
- (xi) Whether the company has furnished to the Bank within the stipulated period the half-yearly return on prudential norms as specified in the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

14.15 Advanced Auditing and Professional Ethics

(xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

(C) In the case of a non-banking financial company not accepting public deposits:

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely: -

- (i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;
- (ii) Whether the company has accepted any public deposits during the relevant period/year;
- (iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- (iv) In respect of Systemically Important Non-deposit taking NBFCs as defined in paragraph 2(1)(xix) of the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007
 - (a) whether the capital adequacy ratio as disclosed in the return submitted to the Bank in form NBS- 7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;
 - (b) whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

(D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions: Apart from the matters enumerated in (A)(i) above, the auditor shall include a statement on the following matters, namely:

Where a Company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank whether the company is complying with the conditions stipulated as advised by the Bank.

4. Reasons to be stated for unfavourable or qualified statements: Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefore.

5. Obligation of auditor to submit an exception report to the Bank

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:

- (a) the provisions of Chapter III B of Reserve Bank of India Act, 1934 (Act 2 of 1934); or
- (b) the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998; or
- (c) Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007; or
- (d) Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

14.5.2 Compliance with CARO 2016: As per CARO 2016 the auditor is required to report that “Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained. [Paragraph 3(xvi)]”

1. Relevant Provisions:

- (a) The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company.**
- (b) The Reserve Bank of India restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration. The relevant Text of the Section 45-IA is reproduced in Appendix XI to this Guidance Note.**
- (c) A Non-Banking Financial Company (NBFC) is a company registered under the Act, engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any**

institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

As per response to an FAQ as given by Reserve Bank of India, "Financial activity as principal business is when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term 'principal business' is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as 50-50 test and is applied to determine whether or not a company is into financial business."

- (d) *NBFCs are doing functions similar to banks, however there exist difference between banks & NBFCs. NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:*
- (i) *NBFC cannot accept demand deposits;*
 - (ii) *NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;*
 - (iii) *deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.*

As per Reserve Bank of India Act, 1934 Section 45I Clause (c) any company carries on as its business or part of its business any activity considered as carrying on the business of Financial Institution.

(The relevant text of the Section 45I(c) is reproduced in Appendix III to this Guidance Note.)

The Reserve Bank of India defined "net owned fund" as (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting there from (i) accumulated balance of loss; (ii)

deferred revenue expenditure; and (iii) other intangible assets; and (b) further reduced by the amounts representing– (1) investments of such company in shares of– (i) its subsidiaries; (ii) companies in the same group; (iii) all other non-banking financial companies; and (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,– (i) subsidiaries of such company; and (ii) companies in the same group, to the extent such amount exceeds ten per cent of (a) above. (“Subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.)

2. Audit Procedures and Reporting

- (a) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.**
- (b) The financial statements should be examined to ascertain whether company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.**
- (c) Whether the company has net owned funds as required for the registration as NBFC.**
- (d) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.**
- (e) The auditor should report incorporating the following:-**
 - (i) Whether the registration is required under section 45-IA of the RBI Act, 1934.**
 - (ii) If so, whether it has obtained the registration.**
 - (iii) If the registration not obtained, reasons thereof.**

(Note: Students are required to refer Guidance Note on CARO, 2016 for more details).

Audit under Fiscal Laws

15.1 Introduction

For ensuring compliance sometimes audit becomes a necessity. Therefore, various statutes, including legislations governing direct and indirect tax provisions have incorporated audit provisions in some or the other form. Under direct taxes, the Central Board of Direct taxes has posed onerous responsibility on the auditor via Income-tax Act, 1961 which has various provisions requiring compulsory audit. However, with the growing importance of the indirect taxes in the economy, the Government is realizing the need of audit by independent bodies especially equipped to do the same. Introduction of audit provisions in the newly introduced Value Added Tax (VAT) legislations is a step towards this direction. Various state Governments have incorporated compulsory audit provisions in their respective State VAT legislations. Various provisions relating tax audit are discussed in this Chapter.

15.2 Audit(s) under the Income-Tax Act, 1961

The Income-tax Act, 1961 (hereinafter referred to as the Act) contains several provisions for audit of accounts of public charitable trusts, non-corporate assesses and other assesses to meet the specific objectives of the Act. Under the Act, several sections such as 12A, 35D, 35E, 44AB, 80IA, 80-IAB, 80-IB, 80-IC, 80-ID, 80-IE, 142(2A), etc., require audit of accounts for tax purposes. We shall discuss the requirements of some of these provisions from the audit angle.

Who can audit the Accounts under the Income-tax Act -Normally, in all the sections referred to above, subject to the exceptions specifically provided, the audit is to be conducted by an 'accountant', as defined in the Explanation below Section 288(2) of the Act. For the purpose of meaning of 'Accountant' as explained under section 288(2), students may refer Para 15.3.1.

15.2.1 Audit of Public Trusts: Section 12A of the Act deals with the conditions as to registration of trust etc. According to this section, exemption from Income tax would be available under sections 11 and 12 of the Income tax Act in relation to the income of any trust or institution provided the following conditions are satisfied:

- (A) Clause (a) of section 12A requires a charitable or religious trust or institution to make an application for registration within one year from the date of creation of the trust or establishment of the institution. The Commissioner is empowered to condone the delay in making the application for registration if he is satisfied that there were sufficient reasons for such delay. In such cases, the exemption provisions of section 11 and 12 would apply from the date of creation of the trust or establishment of the institution.

This requirement of filing an application for registration under section 12A within one year of creation of the religious or charitable trust or institution has been removed. The application can be filed at any time now. This has been provided by insertion of new clause (aa) in section 12A(1). Further, a proviso has been inserted in clause (a) to restrict the applicability of that clause to applications made prior to 1.6.2007.

Also, the power of the Commissioner to grant registration for past years, by condoning the delay in filing such application, has been removed.

Accordingly, in respect of applications filed on or after 1st June, 2007, the provisions of sections 11 and 12 shall apply from the assessment year relevant to the financial year in which the application is made i.e. the exemption would be available only with effect from the assessment year relevant to the previous year in which the application is filed. It would not be available in respect of any earlier assessment year.

- (B) Where the total income of the trust or institution as computed under this Act, without giving effect to the provisions of Sections 11 and 12 exceeds the maximum amount which is not chargeable to income tax in any previous year i.e. ₹ 2,50,000 for the A.Y. 2016-17, the accounts of the trust or institution for that year have been audited by an accountant as defined in the explanation below sub-section (2) of Section 288 and the person in receipt of the income furnishes along with the return of Income for the relevant assessment year, the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed. Rule 17B of the Income tax Rules, 1962 provides that the report of audit of accounts of a trust or institution which is required to be furnished under Clause (b) of Section 12A should be in Form No. 10B. The audit programme is outlined in the following paragraphs:

(a) Preliminary:

- (i) Obtain a resolution from the trust specifying the appointment as also indicating the scope of audit. In particular, the resolution should specify the duties of the auditor in relation to the items specified in the annexure to the prescribed Form No. 10B.
- (ii) Obtain a letter of appointment from the trust. Although the audit may have been conducted in the past by a person appointed as an auditor for the purpose of Section 12A, having regard to the spirit of the requirement contained in clause (8) of Part-I of Schedule I to the Chartered Accountants Act, 1949, it is suggested that the auditor appointed for the purpose of Section 12A, should, before accepting the audit, communicate with such previous auditor.
- (iii) Obtain a certificate as to the opening balances of assets and liabilities and the fund.
- (iv) Obtain a list of books of accounts which are maintained by the trust.
- (v) Obtain a certificate from the trust as to the system of accounting and internal control.
- (vi) Obtain from the trust a list of the institutions/ activities run/carried out by the

15.3 Advanced Auditing and Professional Ethics

trust.

- (vii) Obtain from the trust a certified true copy of the Deed of Trust or any other scheme containing the objects and conditions of the trust as operative from time to time.
- (b) Routine Checking:
- (i) Check the books of account and other records having regard to the system of accounting and internal control.
 - (ii) Vouch the transactions of the trust to satisfy that:
 - (a) the transaction falls within the ambit of the trust;
 - (b) the transaction is properly authorised by the trustees or other delegated authority as may be permissible in law;
 - (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
 - (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust; and
 - (e) amounts shown as applied towards the object of the trust are covered by the objects of the trust as specified in the document governing the trust.
 - (iii) Obtain a trial balance on the closing date certified by the trustees.
 - (iv) Obtain the Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.
- (c) Accounting Principles: The auditor should follow, i.e., generally accepted accounting principles and ascertain the accuracy, truth and fairness of the Balance Sheet and Profit & Loss Account.
- In particular, the auditor will scrutinise that:
- (i) all assets of the trust are verified;
 - (ii) the assets of the trust have been properly valued and depreciation duly provided for;
 - (iii) all liabilities of the trust are properly accounted for;
 - (iv) the investments of the trust are properly classified and indicated and market values shown; and
 - (v) outstanding due to the trust are properly accounted for and their recoverability examined and provision made for irrecoverable.
- (d) Annexure to the Audit Report:
- (i) Obtain from the trustees, a certified list of persons covered by Section 13(3).
 - (ii) Obtain from the trustees, a statement enlisting the various items specified in

the Annexure to Form No. 10B and giving the information against each item together with explanatory or supporting schedules.

- (iii) Verify the information supplied by the trustees in the statements specified above in the light of available material. Where a list of persons specified in Section 13(3) is not available, indicate against Sections II and III of the items specified in the annexure the appropriate qualifying remarks.

The audit report is required to be furnished to the relevant year. Failure to furnish the report will disentitle the trust or institution to the benefit of Sections 11 and 12. The Auditor can accept as correct the list of persons covered by Section 13(3) as given by the managing trustees.

15.2.2 Audit of accounts in connection with the claim for deduction under Sections 35D and 35E: The conditions under which certain specified preliminary expenditure incurred before the commencement of business and once the business is commenced on expanding an industrial undertaking or in connection with setting up a new industrial unit can be amortised are stated in Section 35D of the Act. The manner in which deductions are allowed in respect of expenditure on any prospecting operations relating to certain specified minerals listed in the Seventh Schedule to the Act are stated in Section 35E of the Act. In respect of assessee other than a company or a co-operative society, these deductions are admissible only if the accounts for, the year or years in which the above specified expenditure is incurred are audited by an “accountant” as defined in explanation below sub-section (2) of section 288 of the Income-tax Act, 1961 and the report of such audit is furnished by the assessee along with the return of income. Rule 6AB of the Income-tax Rules 1962 provides that the report of audit required to be furnished by the above-mentioned assessee under section 35D and 35E should be in Form No.3AE. While doing the audit, the auditor is expected to follow general principles of auditing as mentioned in Standards on Auditing.

15.3 Tax Audit under Section 44AB

Section 44AB provides for the compulsory audit of accounts of certain persons carrying on business or profession. Section 44AB reads as under:

“Audit of accounts of certain persons carrying on business or profession”.

Every person -

- (a) carrying on business shall, if his total sales, turnover or gross receipts, as the case may be, in business exceed or exceeds one crore rupees in any previous year.
- (b) carrying on profession shall, if his gross receipts, in profession exceed twenty five lakhs rupees in any previous year,
- (c) carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AE or section 44BB or section 44BBB as the case may be, and he has claimed his income to be lower than the profits or gains so deemed to be the profits and gains of his business, as the case may be, in any previous year,

15.5 Advanced Auditing and Professional Ethics

- (d) carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AD, and he has claimed such income to be lower than the profits and gains so deemed to be the profits and gains of his business and his income exceeds the maximum amount which is not chargeable to income-tax in any previous year,

get his accounts of such previous year audited by an accountant before the specified date and furnish by that date the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed.

Provided that this section shall not apply to the person, who derives income of the nature referred to in section 44B or section 44BBA on and from the 1st day of April, 1985 or, as the case may be, the date on which the relevant section came into force, whichever is later.

Provided further that in a case where such person is required by or under any other law to get his accounts audited, it shall be sufficient compliance with the provisions of this section if such person gets the accounts of such business or profession audited under such law before the specified date and furnishes by that date the report of the audit as required under such other law and a further report by an accountant in the form prescribed under this section.

Explanation: For the purposes of this section,

- (i) "accountant" shall have the same meaning as in the explanation below sub-section (2) of Section 288;
- (ii) "specified date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the due date for furnishing the return of income under sub-section (1) of section 139.

The above section stipulates that every person carrying on business is required to get his accounts audited before the "specified date" by a chartered accountant, if the total sales turnover or gross receipts in the business in any previous year exceed ₹ 1 crore. A person carrying on a profession will also have to get his accounts audited before the "specified date" by a chartered accountant if his gross receipts in profession in any previous year exceed ₹ 25 lakhs w.e.f. A.Y. 2013-14.

Clause (c) of Section 44AB, provides that in the case of an assessee carrying on a business of the nature specified in sections 44AE, 44BB or 44BBB, tax audit will be required if he claims his income to be lower than the presumptive income deemed under those sections. Therefore, such assessee will be required to have a tax audit even if their sales, turnover or gross receipts do not exceed ₹ 100 lakhs (one crore rupees).

If a person is carrying on business(es), coming within the scope of sections 44AE, 44BB or 44BBB but he exercises his option given under these sections to get his accounts audited under Section 44AB, tax audit requirements would apply, in respect of such business(es) even if the turnover of such business(es) does not exceed ₹ 100 lakhs (one crore rupees).

In the case of a person carrying on businesses covered by sections 44AE, 44BB or 44BBB and opting for presumptive taxation, tax audit requirement would not apply in respect of such businesses, if such person is carrying on other business(es) not covered by presumptive

taxation, tax audit requirements would apply in respect thereof if the turnover of such business(es), other than the business covered by presumptive taxation thereof, exceed ₹ 100 lakhs (one crore rupees).

The first proviso to section 44AB stipulates that the provisions of that section will not be applicable to a person who derives income of the nature referred to in sections 44B, or 44BBA. Where the assessee is carrying on any one or more of the businesses specified in section 44B or 44BBA referred to in the first proviso to section 44AB, the sales/turnover/gross receipts from such businesses shall not be included in the total sales/turnover/gross receipts for determining the applicability of section 44AB.

The report of such audit, duly signed and verified by the chartered accountant is required to be given in such form and setting forth such particulars as prescribed by the Board. Rule 6G provides that such audit report and particulars should be given in Form No. 3CA/3CB as may be applicable and the statement of particulars should be given in Form No.3CD.

A question may arise in the case of an assessee who is eligible to claim deductions under sections 80-IA, 80-IB, 80-IC etc., as to whether, it will be necessary for him to get separate audit reports/certificates under these sections in addition to an audit report under Section 44AB. The requirement of section 44AB is a general requirement covering the overall position of the accounts of the assessee. This applies to the consolidated accounts of the assessee for the relevant previous year covering the results of all the units owned by the assessee whether situated at one place or at different places. If turnover of all the units put together exceeds prescribed limits, the assessee would be required to get a separate audit report/certificate under above said sections he wants to avail deduction under the respective sections. Therefore it will be necessary for an assessee to get separate audit reports/certificates under above said sections in addition to an audit report, if any, required under section 44AB.

15.3.1 Tax Auditor: The term “accountant” has been defined in sub-clause (i) of Explanation to Section 44AB as under:

“accountant” shall have the same meaning as in the Explanation below sub-section (2) of Section 288”.

1. The above-mentioned explanation read as under-

"Accountant" means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 who holds a valid certificate of practice under sub-section (1) of section 6 of that Act, but does not include [except for the purposes of representing the assessee under sub-section (1)]—

- (a) in case of an assessee, being a company, the person who is not eligible for appointment as an auditor of the said company in accordance with the provisions of sub-section (3) of section 141 of the Companies Act, 2013 (18 of 2013); or
- (b) in any other case,—
 - (i) the assessee himself or in case of the assessee, being a firm or association of persons or Hindu undivided family, any partner of the firm, or member of the association or the family;

15.7 Advanced Auditing and Professional Ethics

- (ii) in case of the assessee, being a trust or institution, any person referred to in clauses (a), (b), (c) and (cc) of sub-section (3) of section 13;
 - (iii) in case of any person other than persons referred to in sub-clauses (i) and (ii), the person who is competent to verify the return under section 139 in accordance with the provisions of section 140;
 - (iv) any relative of any of the persons referred to in sub-clauses (i), (ii) and (iii);
 - (v) an officer or employee of the assessee;
 - (vi) an individual who is a partner, or who is in the employment, of an officer or employee of the assessee;
 - (vii) an individual who, or his relative or partner—
 - (I) is holding any security of, or interest in, the assessee:
Provided that the relative may hold security or interest in the assessee of the face value not exceeding one hundred thousand rupees;
 - (II) is indebted to the assessee:
Provided that the relative may be indebted to the assessee for an amount not exceeding one hundred thousand rupees;
 - (III) has given a guarantee or provided any security in connection with the indebtedness of any third person to the assessee:
Provided that the relative may give guarantee or provide any security in connection with the indebtedness of any third person to the assessee for an amount not exceeding one hundred thousand rupees;
 - (viii) a person who, whether directly or indirectly, has business relationship with the assessee of such nature as may be prescribed;
 - (ix) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.
2. The proviso to section 44AB lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person gets the accounts of such business or profession audited under such other law before the specified date and furnishes by that date the report by an 'accountant' as required under section 44AB. It may be noted that after amendment by the Finance Act, 2001, tax audit can be carried out by an accountant only. Accordingly, in case of any assessee like a co-operative society where the accounts under the relevant law have been audited by a person other than a chartered accountant, the tax audit will have to be conducted by the 'accountant' as defined under section 44AB.
3. Though the section refers to the accounts being audited by an accountant, which means a chartered accountant as defined above, the audit can also be done by a firm of chartered accountants. This has been a recognised practice under the Act. In such a case, it would be necessary to state the name of the partner who has signed the audit report on behalf of the firm. The member signing the report as a partner of a firm or in his

individual capacity should give his membership number while registering himself in the e-filing portal.

4. Section 44AB stipulates that only Chartered Accountants should perform the tax audit. This section does not stipulate that only the statutory auditor appointed under the Companies Act or other similar Statute should perform the tax audit. As such the tax audit can be conducted either by the statutory auditor or by any other chartered accountant in full time practice.
5. Tax audit under section 44AB being a recurring audit assignment, for expressing professional opinion on the financial statements and the particulars, the member accepting the assignment should communicate with the member who had done tax audit in the earlier year as provided in the Chartered Accountants Act. When making the enquiry from the retiring auditor, the member accepting the assignment should find out whether there are any professional or other reasons why he should not accept the appointment. The professional reasons for not accepting the appointment include:
 - ◆ Non-compliance of the provisions of sections 224 and 225 of the Companies Act as mentioned in Code of Ethics issued by ICAI under Clause (9) of Part I of First Schedule to Chartered Accountants Act, 1949. Sections 224 and 225 have been replaced with section 139/142 and section 140 respectively in Companies Act, 2013.
 - ◆ Non-payment of undisputed audit fees by auditees other than in case of sick units for carrying out the statutory audit under the Companies Act or various other statutes.
 - ◆ Issuance of qualified report.
6. The tax auditor should obtain from the assessee a letter of appointment for conducting the audit as mentioned in section 44AB. It is advisable that such an appointment letter should be signed by the person competent to sign the return of income in terms of the provisions of section 140. It would also be useful if the letter affirms that no other auditor was appointed to conduct the tax audit for the year for which the appointment is being made. The letter may also give the name and address of the tax auditor for the previous year, wherever relevant. This would give the necessary information to the incoming tax auditor to enable him to communicate with the previous auditor. The letter of appointment should also specify the remuneration of the tax auditor. SA 210 – “Agreeing the Terms of Audit Engagement” issued by the ICAI requires that the auditor to agree with the terms of audit engagement with management or those charged with governance as appropriate. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of written agreement.
7. The tax auditor should get the statement of particulars, as required in the annexure to the audit report, authenticated by the assessee before he does the same.
8. The Act does not prohibit a relative or an employee of the assessee being appointed as a tax auditor under section 44AB. It may, however, be noted that as per the decision of the Council, a chartered accountant should not express his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial

15.9 Advanced Auditing and Professional Ethics

interest. It may be noted that the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law. Therefore, an employee of an assessee or an employee of a concern under the same management cannot audit the accounts of an assessee under section 44AB.

9. A chartered accountant who is responsible for writing or the maintenance of the books of account of the assessee should not audit such accounts. This principle will apply to the partner of such a member as well as to the firm in which he is a partner. In view of this, a chartered accountant who is responsible for writing or the maintenance of the books of account or his partner or the firm in which he is a partner should not accept tax audit assignment under section 44AB in the case of such an assessee.
10. The audit of accounts of a professional firm of chartered accountants, under section 44AB cannot be conducted by any partner or employee of such firm.
11. A chartered accountant/firm of chartered accountants, who is appointed as tax consultant of the assessee, can conduct tax audit under section 44AB. But an internal auditor of the assessee cannot conduct tax audit if he is an employee of the assessee. The Council of ICAI has decided that an internal auditor of an assessee, whether working with the organisation or independently practicing chartered accountant or a firm of chartered accountants, cannot be appointed as his tax auditor.
12. A question may arise whether an assessee can remove a tax auditor appointed under section 44AB. The answer depends upon the facts and circumstances of the case. It is, however, possible for the management to remove a tax auditor where there are valid grounds for such removal. This may arise where the tax auditor has delayed the submission of audit report under section 44AB for an unreasonable period and if it is found that there is no possibility of getting the audit report uploaded before the specified date. In such cases, the management may be justified in removing the tax auditor. However, the tax auditor cannot be removed on the ground that he has given an adverse audit report or the assessee has an apprehension that the tax auditor is likely to give an adverse audit report. If there is any unjustified removal of tax auditors, the Ethical Standards Board constituted by the Institute can intervene in such cases. No other chartered accountant should accept the audit assignment if the removal of his predecessor is not on valid grounds.
13. Before accepting a tax audit, the chartered accountant should take into consideration the ceiling on tax audit assignments fixed under the Notification dated 13th January, 1989, issued by the ICAI. In view of the said Notification, a member of the Institute in practice, shall be deemed to be guilty of professional misconduct if he accepts in a financial year more than **60-tax audit assignments** or such other limit as may be prescribed by ICAI from time to time under section 44AB, whether in respect of a person whose accounts have been audited under any other law or a person who carries on business or

profession but who is not required by or under any other law to get his accounts audited. Further, as per a Council decision, audits of accounts of persons carrying on business covered by sections 44AE, 44BB or 44BBB is not included in the aforesaid limit.

14. The audit of head office and branch offices of the assessee shall be regarded as one tax audit assignment.
15. A chartered accountant should not accept the tax audit of a person to whom he is indebted for more than rupees ten thousand. Reference should be made to Chapter- X "Appointment of an auditor when he is indebted to a concern" of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August, 2008- whereby a member of the Institute shall be deemed to be guilty of professional misconduct if he accepts appointment as an auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding rupees ten thousand. For this purpose, the limit of ₹ 10,000/- shall be the aggregate amount in respect of the proprietor and/or the partner/s of the firm of chartered accountants.
16. The Council has issued a Guideline which states that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking/Government Company/Listed Company and other Public Company having turnover of ₹ 50 crores or more in a year and accepts any other work or assignment or service in regard to the same undertaking/company on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking/company.
17. The tax auditor is required to upload the tax audit report directly in the e-filing portal.
18. A question may arise in the case of a public sector company or any other company where the statutory auditor has not been appointed by the authorities concerned as to whether the tax auditor appointed under section 44AB can complete his audit without waiting for statutory audit report on the accounts audited by the statutory auditors. It may be noted that Form No. 3CA requires the tax auditor to enclose a copy of the audit report conducted by the statutory auditor or the auditor of the financial statements as the case may be. Where a statutory auditor has not been appointed by the authorities concerned or where the report of the statutory auditor is not available for whatever reasons, it will be possible for the tax auditor to give his report in Form No. 3CB and to certify the relevant particulars in Form No.3CD. This is particularly important in those cases where the assessee concerned has suffered losses in the relevant accounting year. It may, however, be noted that the tax auditor in such cases will have to conduct the financial audit as well in order to enable him to certify whether or not the accounts reported upon by him give a true and fair view of the state of affairs of the assessee whose accounts are audited by him under section 44AB.
19. The appointment of the auditor for tax audit in the case of a company need not be made at the general meeting of the members. It can be made by the Board of Directors or even by any officer, if so authorised by the Board in this behalf. The appointment in the case of a firm or a proprietary concern can be made by a partner or the proprietor or a person

15.11 Advanced Auditing and Professional Ethics

authorised by the assessee. It is possible for the assessee to appoint two or more chartered accountants as joint auditors for carrying out the tax audit, in which case, the audit report will have to be signed by all the chartered accountants. In case of disagreement, they can give their reports separately.

20. The chartered accountants should charge reasonable fees depending upon the responsibility involved under the revised forms and taking into consideration the work involved in tax audit assignment which has increased considerably consequent to the revision of the forms. It is necessary that members of the profession should also maintain reasonable standards of professional fees.

Specified date and tax audit: As per the recent developments, the tax audit report is required to be uploaded using digital signature of the tax auditor. A question may arise whether a tax auditor appointed under section 44AB can be held responsible if he does not complete the audit and if the tax audit report is not uploaded before the specified date. Answer to this question will depend on the facts and circumstances of the case. Normally, it is the professional duty of the chartered accountant to ensure that the audit accepted by him is completed before the due date. If there is any unreasonable delay on his part, he is answerable to the Institute if a complaint is made by the client. However, if the delay in the completion of audit is attributable to his client, the tax auditor cannot be held responsible. It is, therefore, necessary that no chartered accountant should accept audit assignments which he cannot complete within the above time frame.

15.3.2 Income Computation and Disclosure Standards (ICDS): Section 145 of the Income Tax Act, 1961 deals with the method of accounting.

Under section 145(1), income chargeable under the heads "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee.

Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assesseees or in respect of any class of income.

Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assesses (other than an individual or a HUF who is not required to get his accounts of one previous year audited in accordance with the provisions of section 44(AB)) , following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or " Income from other sources". from the A.Y. 2017-18.

All the notified ICDSs are applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts. In the case of conflict between the provisions of the Income-tax Act, 1961 and the notified ICDSs, the provisions of the Act shall prevail to that extent.

The Central Government has prescribed 10 Income Computation and Disclosure Standards (ICDSs) as under:

- A. ICDS I relating to Accounting Policies.**
- B. ICDS II relating to Valuation of Inventories.**
- C. ICDS III relating to Construction Contracts.**
- D. ICDS IV relating to Revenue Recognition.**
- E. ICDS V relating to Tangible Fixed Assets.**
- F. ICDS VI relating to the Effects of Changes in Foreign Exchange Rates.**
- G. ICDS VII relating to Government Grants.**
- H. ICDS VIII relating to Securities.**
- I. ICDS IX relating to Borrowing Costs.**
- J. ICDS X relating to Provisions, Contingent Liabilities and Contingent Assets.**

The above ICDSs are to be followed by all assesses (other than an individual or a HUF who is not required to get his accounts of one previous year audited in accordance with the provisions of section 44(AB)) following mercantile system of accounting. Therefore, it is clear that those assessee who are following cash system of accounting need not follow the ICDSs notified above.

15.3.3 Audit procedures

1. In the case of an audit, the tax auditor is required to express his opinion as to whether the financial statements give a true and fair view of the state of affairs of the assessee in the case of the balance sheet and in the case of the profit and loss account/ income and expenditure account, of the profit/loss or income/expenditure. As regards the statement of particulars to be annexed to the audit report, he is required to give his opinion as to whether the particulars are true and correct. In giving his report the tax auditor will have to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require, considering the contents of the audit report. He will have to conduct the audit by applying the generally accepted auditing procedures which are applicable for any other audit. He can apply the technique of test audit depending on the type of internal control procedures followed by the assessee. The tax auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case. He would be well advised to refer to the Standards on Auditing (SAs) issued by ICAI, as well as the "Guidance Note on Audit Reports and Certificates for Special Purposes". If the statutory auditor of a person is also appointed to undertake tax audit, it is advisable to carry out both the audits concurrently.

2. Section 143 of the Companies Act 2013 gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. No such powers are given to the tax auditor appointed under section 44AB. Attention is invited to SA 210, *Agreeing the Terms of Audit Engagements*. The Standard requires an auditor to establish whether the pre-conditions for an audit are present so as to

15.13 Advanced Auditing and Professional Ethics

accept or continue an audit engagement. As per para 6(b) (iii) the auditor is required to obtain agreement of management that it acknowledges and understands its responsibilities to provide the auditor with (a) access to all information of which the management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters, (b) additional information that the auditor may request the management for the purpose of the audit and (c) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. Moreover, since the appointment of the tax auditor is made by assessee, it will be in the interest of the assessee to furnish all the information and explanations and produce books of account and records required by the tax auditor. If, however, after agreeing to the terms of the engagement, the assessee subsequently refuses to produce any particular record or to give any specific information or explanation in relation to the reporting requirement under section 44AB, the tax auditor should see the impact thereof from the perspective of "management integrity" vis-a-vis overall assessment of risk of misstatements in accordance with under SA 315, *Identifying and Assessing the risks of material misstatement through understanding the entity and its environment* and consequently on his/her opinion for reporting in Clause (3) of Form No. 3CA or Clause (5) of Form No. 3CB as the case may be.

3. The audit report given under section 44AB is to assist the income-tax department to assess the correct income of the assessee. In order that the tax auditor may be in a position to explain any question which may arise later on, it is necessary that he should keep necessary working papers about the evidence on which he has relied upon while conducting the audit and also maintain all his necessary working papers. Such working papers should include his notes on the following, amongst other matters:

- (a) work done while conducting the audit and by whom;
- (b) explanations and information given to him during the course of the audit and by whom;
- (c) decision on the various points taken;
- (d) the judicial pronouncements relied upon by him while making the audit report; and
- (e) certificates issued by the client/management letters.

The requirements of documentation are applicable in respect of tax audit conducted by chartered accountants. For this purpose attention is also invited to SA 230, *Audit Documentation*, which provides that the tax auditor should prepare documentation that provides a sufficient and appropriate record of the basis for the auditor's report and evidence that the audit was planned and performed in accordance with SA's and applicable legal and regulatory requirements.

4. If the accounts of the business or profession of a person have been audited under any other law by the statutory auditor(s), it is not necessary for the tax auditor appointed under section 44AB to conduct the audit once again in the matter of expression of "true and fair view" of the state of affairs of the entity and of its profit/loss for the period covered by the audit. However, the said section envisages the certification of the particulars in the prescribed form on which the tax auditor has to express his opinion as to whether these are 'true and correct'. In other words, where an audit has already been conducted and the opinion of the

auditor has been expressed on the accounts, it would not be necessary to repeat the entire exercise to express similar opinion all over again. The tax auditor has only to annex a copy of the audited accounts and the auditor's report and other documents forming part of these accounts to his report and verify the particulars in the prescribed form for expressing his opinion as to whether these are true and correct.

5. Just in case of the conduct of a statutory audit for the purpose of expression of the auditor's opinion as to whether the financial statements depict a 'true and fair' view, the statutory auditor applies audit sampling, in case of tax audits also the tax auditor may apply audit sampling techniques as prescribed in SA 530, *Audit Sampling* on the information provided by the assessee to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.. The extent of check undertaken would have to be indicated by the tax auditor in his working papers and audit notes. The tax auditor would be well advised to so design his tax audit programme as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

6. Where the assessee has been subjected to an internal audit and the tax auditor decides to use the work of the internal auditor for the purpose of the tax audit under section 44AB, the latter's procedures would be guided by the principles laid down in Standard on Auditing (SA) 610, *Using the Work of Internal Auditors*.

7. Audit procedures applicable to a person whose accounts of the business or profession have been audited under any other law will apply as well to a person who carries on business or profession but who is not required by or under any other law to get his accounts audited. In order to express his opinion on the accounts of a person belonging to the latter category the tax auditor should apply the same tests and checks as he would have applied in the conduct of audit of the former category. These may include disclosure regarding method of accounting and practices consistently and regularly followed, and whether a change in such matters or practice has been made during the year, notwithstanding the fact that such disclosures are required to be made in Form No.3CD.

8. The ICAI had pursuant to the issuance of the Revised SA 700, *Forming an Opinion and Reporting on Financial Statements*, prescribed a revised format of the auditor's report on financial statements, which has been made effective in respect of audits of financial statements for periods beginning on or after 1st April 2012. Since Form No. 3CA and Form No. 3CB are required to be filed online in a preset form and the same are not in line with the requirements of SA 700, there is no specifically allocated field for providing information relating to the respective responsibilities of the assessee and the tax auditor as required in terms of the principles laid out in SA 700. However, having regard to the importance of these respective responsibility paragraphs from the perspective of the readers of the tax audit report, it is suggested that these respective responsibility paragraphs relating can be provided in the space provided for giving observations, etc., under Clause (3) of Form No. 3CA or Clause (5) of Form No. 3CB as the case may be.

While test checks may suffice in the conduct of a statutory audit for the expression of the auditor's opinion as to whether the accounts depict a 'true and fair' view, the tax auditor may be required to apply reasonable tests on the total information to be prepared by the assessee

15.15 Advanced Auditing and Professional Ethics

in respect of certain items in the prescribed form, e.g., in verification of payments for purchases/expenses exceeding ₹ 20,000/- in cash. While the entity may have to prepare the details for the entire year, the tax auditor may have to ensure that no items have been omitted in the information furnished and a reasonable test check would reveal whether or not the information furnished is correct. The extent of check undertaken would have to be indicated by the tax auditor in his working papers and audit notes. The tax auditor would be well advised to so design his tax audit programme as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

15.3.4 Audit report: Section 44AB requires the tax auditor to submit the audit report in the prescribed form and setting forth the prescribed particulars. Sub-rule 1 of rule 6G provides that the report of audit of accounts of a person required to be furnished under Section 44AB shall -

- (a) in the case of a person who carries on business or profession and who is required by or under any other law to get his accounts audited, be in Form No. 3CA;
- (b) in the case of a person who carries on business or profession, but not being a person referred to in clause (a), be in Form No. 3CB.

Sub-rule (2) of Rule 6G further provides that the particulars which are required to be furnished under Section 44AB shall be in Form No. 3CD.

It may be noted that the audit report in Form No.3CB is in two parts. The first part requires the tax auditor to give his opinion as to whether or not the accounts audited by him give a true and fair view:

- (i) in the case of the balance sheet, of the state of affairs as at the last date of the accounting year.
- (ii) in the case of the profit and loss account, of the profit or loss of the assessee for the relevant accounting year.

The second part of the report states that the statement of particulars required to be furnished under section 44AB is annexed to the audit report in Form No. 3CD. The tax auditor is required to give his opinion whether the prescribed particulars furnished by the assessee are true and correct subject to observations and qualifications, if any.

In paragraph 3 of Form No. 3CB the auditor has to report that the financial statements audited by him give a 'true' and fair view. The requirement in paragraph 3 of Form No. 3CA and paragraph 5 of Form No. 3CB relating to particulars in Form No. 3CD is that the auditor should report that these particulars in Form No. 3CD are "true and correct". The terminology "true and fair" is widely understood though not defined even under the Companies Act, 2013. On the other hand, the words "true and correct" lay emphasis on factual accuracy of the information. In this context reference is invited to AS-1 and AS(IT)-I relating to disclosure of accounting policies. These standards recognise that the major considerations governing the selection and application of accounting policies are (i) prudence, (ii) substance over form and (iii) materiality. Therefore, while giving particulars in Form No.3 CD these aspects should be kept in view. In particular, considering the nature of particulars to be given in Form No. 3CD, the aspect of materiality should be considered. In other words, particulars should be given in the respect of

material items and the auditors should ensure factual accuracy relating to these particulars. In the case of a person whose accounts of the business or profession have been audited under any other law, it is not required for the tax auditor appointed under section 44AB to give his opinion, as to whether or not the accounts give a true and fair view as indicated herein above. It would only be necessary for him to annex a copy of the audited accounts as well as a copy of the audit report given by the statutory auditor with his report in Form No. 3CA along with Form No. 3CD.

In the case of a person who carries on business and also renders professional services but who is not required by or under any other law to get his accounts audited, report should be given in Form No. 3CB. The statement of particulars should be given in Form No. 3CD.

In the case of "person" having their accounting year which is different from the financial year, accounts of the financial year are required to be prepared and audited. The audit report shall be in Form 3CB.

Form No. 3CA

1. This form is to be used in a case where the accounts of the business or profession of a person have been audited under any other law. The first part of the report refers to the fact that the statutory audit of the assessee was conducted by a chartered accountant or any other auditor in pursuance of the provisions of the relevant Act, and the copy of the audit report along with the audited profit and loss account and balance sheet and the documents declared by the relevant Act to be part of or annexed to the profit and loss account and balance sheet, are annexed to the report in Form No. 3CA. In a case where the tax auditor carrying out the audit under section 44AB is different from the statutory auditor, a reference should be made to the name of such statutory auditor. In case the statutory auditor is carrying out the audit under section 44AB, the fact that he has carried out the statutory audit under the relevant Act should be stated. Attention of the members in this context is invited to SA 600 "Using the work of Another Auditor".

2. Statement of particulars required to be furnished under section 44AB is annexed with the particulars in Form No. 3CD. The tax auditor has to further state that, in his opinion and to the best of his information and according to examination of books of account including other relevant documents and explanations given to him, the particulars given in the said Form No. 3CD and the annexure thereto are true and correct subject to the observations/qualifications, if any.

3. The auditor is required to examine not only the books of accounts but also other relevant documents directly related to transactions reflected in the books of accounts like original purchase invoice, copy of bank statements, bills, vouchers, various agreements/ contracts or any other document on the basis of which preliminary entries are passed in the books of accounts.

4. Attention is also drawn to the definition of 'document' as per section 2(22AA) of the Act which is as under:

"document" includes an electronic record as defined in clause (t) of sub-section (1) of section 2 of the Information Technology Act, 2000 (21 of 2000).

Section 2(1)(t) of the Information Technology Act, 2000 as referred above is reproduced below:

15.17 Advanced Auditing and Professional Ethics

"electronic record" means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche.

The definition of term "document" is an inclusive definition and includes within its ambit documents other than those considered as electronic record as per section 2(1)(t) of the Information Technology Act, 2000. The above definition will also be considered while reporting under clause 11(c) of Form No. 3CD discussed later.

5. Where any of the requirements in this form is answered in negative or with qualification, the report shall state the reasons thereof. The tax auditor should state this qualification in the audit report so that the same becomes a comprehensive report and the user of the audited statement of particulars can realize the impact of such qualifications.

6. It is possible that in the case of a person whose accounts of the business or profession have been audited under any other law, which has branches at various places, the branch accounts might have been audited by branch auditors under the statute. If the audit under section 44AB is also carried out by the same branch auditors or other chartered accountants, they should submit the report in Form No. 3CA to the management or the principal tax auditor appointed for the head office under Section 44AB. Attention in this regard is drawn to SA 600, "Using the Work of Another Auditor" which discusses the procedures in this regard as well as the principal tax auditor's responsibility in relation to his use of the work of the branch auditor. The principal tax auditor should submit his consolidated report on the registered office/head office and branch accounts and report in his tax audit report as his observation in paragraph 3 of Form No. 3CA as under:

"I/We have taken into consideration the audit report and the audited statements of accounts, and particulars received from the auditors, duly appointed under the relevant law, of the branches not audited by me/us".

7. Item No. 4 of the notes to Form No. 3CA requires that the person, who signs this audit report, shall indicate reference of his membership No./certificate of practice number/authority under which he is entitled to sign this report. No separate certificate of practice number is allotted by ICAI. As such, where a chartered accountant acts as a tax auditor he should give his membership number with ICAI while registering himself in the e-filing portal. In case, the e-filing utility of Form No. 3CA requires the mention of the Firm Registration number and the name of the firm on whose behalf the member has conducted audit, the same should invariably be provided by the tax auditor.

8. An assessee may have one or more branches outside India. The accounts of such branches are normally audited by the professional accountants overseas. The results of such branches are also incorporated in the consolidated accounts prepared in this country. In the case of foreign branches, the relevant information in respect of such branches as is required by Form No. 3CD, may be obtained by the tax auditor in India from the assessee who should obtain the same from the overseas auditor who had audited the accounts of such foreign branches. The tax auditor in India while certifying the information in Form No. 3CD may rely upon the information obtained by him from the overseas auditor and while submitting his consolidated report in Form No. 3CD, he should specifically point out the following in his audit report in paragraph 3 of Form No. 3CA as his observation:-

“I/We have taken into consideration the audit report and the audited statements of accounts, and particulars received from the auditors, appointed under the relevant law, of the overseas branches not audited by me/us”.

If the assessee is unable to obtain relevant information in respect of the overseas branches duly certified by the overseas auditor, the relevant facts should be suitably disclosed and reported upon.

9. Where the tax auditor is unable to obtain the required information in respect of branches situated in India or outside India then the fact should be suitably disclosed along with its impact on the Auditor's opinion on the particulars furnished in Form No. 3CD, as an observation in clause (3) of Form No. 3CA. Reference is drawn to SA 705 “Modifications to the opinion in the Independent Auditor's report”.

Form No. 3CB

1. In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the audit report has to be given in Form No. 3CB. Form No. 3CB consists of five paragraphs.

2. The tax auditor has to state whether he has examined the balance sheet as on a particular relevant date and the profit and loss account/income and expenditure account for that period. Further, such a balance sheet and the profit and loss account must be attached with the audit report.

3. The tax auditor has to certify that the balance sheet and the profit and loss account/income and expenditure account are in agreement with the books of account maintained at the head office and branches. Also, he has to mention the total number of branches.

4. He has to report his observations, comments, discrepancies or inconsistencies, if any. Subject to the above observations, comments, discrepancies, inconsistencies he has to state whether:

- (a) he has obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purposes of the audit;
- (b) in his opinion proper books of account have been kept by the head office and branches of the assessee so far as appears from his examination of the books;
- (c) in his opinion and to the best of his information and according to the explanations given to him the said accounts, read with notes thereon, if any, give a true and fair view;
 - (i) in the case of the balance sheet of the state of the affairs of the assessee as at 31st March, _____ and
 - (ii) in the case of the profit and loss account/income and expenditure account of the profit/loss or surplus/deficit of the assessee for the year ended on that date.

5. Under clause (a) of paragraph 3 of Form No. 3CB, the tax auditor has to report his “observations /comments/ discrepancies/ inconsistencies,” if any. The expression “Subject to

15.19 Advanced Auditing and Professional Ethics

above” appearing in clause (b) makes it clear that such observations /comments/ discrepancies/ inconsistencies which are of qualificatory nature relate to necessary information and explanations for the purposes of the audit or the keeping of proper books of accounts or the true and fair view of the financial statements, respectively to be reported on in paragraphs (A), (B) and (C) under clause (b) of paragraph 3. While reporting on clause (a) of paragraph 3 of Form No. 3CB the tax auditor should report only such of those observations/comments/ discrepancies/ inconsistencies which are of qualificatory nature which affect his reporting about obtaining all the information and explanations which were necessary for the purposes of the audit, about the keeping of proper books of account by the head office and branches of the assessee and about the true and fair view of the financial statements. Further, only such observations/comments/ discrepancies/inconsistencies which are of a qualificatory nature should be mentioned under clause (a). Any other observations/ comments/ discrepancies/ inconsistencies, which do not affect the reporting on the matters specified above may form part of the notes to accounts forming part of the accounts. In case the tax auditor has no observations/ comments/ discrepancies/ inconsistencies to report which are of qualificatory nature, “NIL” should be reported in this part of paragraph 3. The tax auditor may then give his report as required by sub-paragraphs (A), (B), and (C) of paragraph 3 and paragraph 4.

6. Paragraph 4 of Form No. 3CB provides that the prescribed particulars are furnished in Form No. 3CD annexed to the report. Paragraph 5 of Form No. 3CB requires the auditor to report whether in his opinion and to the best of his information and according to the explanations given to him, the particulars given in Form No. 3CD are true and correct subject to observations/qualifications, if any. The auditor may have a difference of opinion with regard to the particulars furnished by the assessee and he has to bring these differences under various clauses in Form No. 3CD. The auditor should make a specific reference to those clauses in Form No. 3CD in which he has expressed his reservations, difference of opinion, disclaimer etc. in this paragraph.

7. If a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, has branches and separate accounts are maintained at the branches, the assessee can request the tax auditor appointed under section 44AB to audit the head office and branch accounts. In the alternative, the assessee can appoint separate tax auditors for branches. The branch tax auditor in such a case will have to give an audit report in Form No. 3CB to the management or the tax auditor appointed for the audit of head office accounts. The tax auditor appointed for the audit of head office can rely on the report of branch tax auditors subject to such checks and verifications as he may choose to make and shall submit his consolidated report on the head office and branch accounts. He should make suitable reference to the audit conducted by separate branch tax auditors in the same manner as stated in point 6 above.

8. If the tax auditor is called upon to give his report only in respect of one or more businesses carried on by the assessee and the books of accounts of the other businesses are not produced as the same are not required to be audited under the Act, the tax auditor should mention the fact that audit has not been conducted of those businesses whose books of account had not been produced. However, if the financial statements include, inter alia, the

results of such business for which books of account have not been produced, the auditor should qualify his report in Form No. 3CB.

Form No. 3CD

1. The statement of particulars given in Form No. 3CD as annexure to the audit report contains forty one clauses. The tax auditor has to report whether the particulars are true and correct. This Form is a statement of particulars required to be furnished under section 44AB. The same is to be annexed to the reports in Forms No. 3CA and 3CB in respect of a person who carries on business or profession and whose accounts have been audited under any other law and in respect of person who carries on business or profession but who is not required by or under any other law to get his accounts audited respectively.
2. As stated earlier, the tax auditor should obtain from the assessee, the statement of particulars in Form No. 3CD duly authenticated by him. It would be advisable for the assessee to take into consideration the following general principles while preparing the statement of particulars:
 - (a) He can rely upon the judicial pronouncements while taking any particular view about inclusion or exclusion of any items in the particulars to be furnished under any of the clauses specified in Form No. 3CD.
 - (b) If there is a conflict of judicial opinion on any particular issue, he may refer to the view which has been followed while giving the particulars under any specified clause.
 - (c) The AS, Guidance Notes, SA issued by the Institute from time to time should be followed.
3. While furnishing the particulars in Form No. 3CD it would be advisable for the tax auditor to consider the following:
 - (a) If a particular item of income/expenditure is covered in more than one of the specified clauses in the statement of particulars, care should be taken to make a suitable cross reference to such items at the appropriate places.
 - (b) If there is any difference in the opinion of the tax auditor and that of the assessee in respect of any information furnished in Form No. 3CD, the tax auditor should state both the view points and also the relevant information in order to enable the tax authority to take a decision in the matter.
 - (c) If any particular clause in Form No. 3CD is not applicable, he should state that the same is not applicable.
 - (d) In computing the allowance or disallowance, he should keep in view the law applicable in the relevant year, even though the form of audit report may not have been amended to bring it in conformity with the amended law.
 - (e) In case the prescribed particulars are given in part or piecemeal to the tax auditor or relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the auditor should not withhold the entire audit report. In such a case, he can qualify his report on matters in respect of which information is not furnished to

15.21 Advanced Auditing and Professional Ethics

him. In the absence of relevant information, the tax auditor would have no option but to state in his report that the relevant information has not been furnished by the assessee.

- (f) The information in Form No. 3CD should be based on the books of accounts, records, documents, information and explanations made available to the tax auditor for his examination.
- (g) In case the auditor relies on a judicial pronouncement, he may mention the fact as his observations in clause (3) of Form No. 3CA or clause (5) provided in Form No. 3CB, as the case may be.

Particulars to be furnished in Form No. 3CD

PART – A

1.	Name of the assessee		
2.	Address		
3.	Permanent Account Number		
4.	Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty, etc. If yes, please furnish the registration number or any other identification number allotted for the same		
5.	Status		
6.	Previous year		from _____ to _____
7.	Assessment year		
8.	Indicate the relevant clause of section 44AB under which the audit has been Conducted		

[Clauses 1 to 8]

The requirements of clauses 1 to 8 of Part-A are discussed as follows:

- ❖ **Under clause (1)**, the name of the assessee whose accounts are being audited under section 44AB should be given. However, if the tax audit is in respect of a branch, name of such branch should be mentioned along with the name of the assessee.
- ❖ The address to be mentioned **under clause (2)** should be the same as has been communicated by the assessee to the Income-tax Department for assessment purposes as on the date of signing of the audit report. If the tax audit is in respect of a branch or a unit, the address of the branch or the unit should be given. In the case of a company, the address of the registered office should also be stated. In the case of a new assessee, the address should be that of the principal place of business.
- ❖ **Under clause (3)**, the permanent account number (PAN) allotted to the assessee should be indicated. It may be noted that in the e-filing format PAN is a mandatory field.
- ❖ **Under clause (4)**, the auditor is required to mention the registration number or any other

identification number, if any, allotted, in case the assessee is liable to pay indirect taxes like excise duty, service tax, sales tax, customs duty, etc. Part A of Form No. 3CD generally requires the auditor to give the factual details of the assessee. Thus, the auditor is primarily required to furnish the details of registration numbers as provided to him by the assessee. The reporting is however, to be done in the manner or format specified by the e-filing utility in this context. The information may be obtained and maintained in the following format:-

Sr. No	Relevant Indirect tax Law which requires registration	Place of Business/ profession/ service unit for which registration is in place/ or has been applied for:-	Registration/ Identification number
1	2	3	4

The auditor has to keep in mind the provisions of Standard on Auditing 580 "Written Representation". In case the auditor prima facie is of the opinion that any indirect taxes laws is applicable on the business or profession of the assessee but the assessee is not registered under the said law, he should report the same appropriately.

- ❖ **Under clause (5)**, the status of the assessee is to be mentioned. Obviously this refers to the different classes of assessee included in the definition of "person" in section 2 (31) of the Act, namely, individual, Hindu undivided family, company, firm, an association of persons or a body of individuals whether incorporated or not, a local authority or artificial juridical person.
- ❖ **Under clause (6)**, the period of the previous year has to be stated. Since the previous year under the Act now uniformly begins on 1st April and ends on 31st March, the relevant previous year should be mentioned. In case of amalgamations, demergers, reconstitution, new business, closure of existing business etc. the date of beginning/ ending of the previous year may be different, the auditor may accordingly, mention the relevant date of beginning and ending of the previous year in this clause. Hence, the tax auditor has to apply his professional judgement depending on the facts and circumstances of the same.
- ❖ **Under clause (7)**, the assessment year relevant to the previous year for which the accounts are being audited should be mentioned.
- ❖ **Under clause (8)**, the auditor is required to mention the relevant clause of section 44AB under which the audit has been conducted. In case the assessee is carrying on business and his total sales, turnover or gross receipts as the case may be, exceeds one crore in the relevant previous year, the auditor is required to mention clause (a) under this head. If the assessee is carrying on profession and his gross receipts exceed twenty five lakh rupees in the relevant previous year, the auditor is required to mention clause (b) under this head. Likewise, if the audit under section 44AB is being conducted by virtue of provisions of section 44AE, 44BB and 44BBB, the auditor is required to mention clause (c). For audit being conducted by virtue of provisions of section 44AD, clause (d) is to be mentioned under this head.

15.23 Advanced Auditing and Professional Ethics

Clause 9(a): If firm or Association of Persons, indicate names of partners/members and their profit sharing ratios.

Clause 9(b): If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change.

Explanation for Clauses 9(a) and 9(b): Where the assessee is a firm or association of persons (AOP) or body of individuals, the names of partners of the firm or members of the association of persons or body of individuals and their profit sharing ratios (%) have to be stated. In case where the partner of a firm or the member of AOP/ BOI acts in a representative capacity, the name of the beneficial partner/member should be stated. Thus, the details of partners or members during the entire previous year will have to be furnished. The term "profit sharing ratios" would include loss-sharing ratio also since loss is nothing but negative profits. This would not cover any specific ratio or understanding in relation to payment of remuneration or interest to partners or members.

If there is any change in the partners of the firm or members of the association of persons/body of individuals or their profit or loss sharing ratio since the last date of the preceding year, the particulars of such change must be stated. All the changes occurring during the entire previous year must be stated.

The particulars in this clause should be verified from the instrument or agreement or any other document evidencing partnership or association of persons including any supplementary documents or other documents effecting such changes. For this purpose, the tax auditor may also verify:

- (i) in case of registered firms (including Indian LLPs), whether the relevant documents have been filed with the concerned authorities,
- (ii) whether notice of changes, if required, has been given to the registrar of firms, and
- (iii) any minutes or any other understanding recording any changes in the partners/members or their profit sharing ratios.

The tax auditor should obtain certified copies of the deeds, documents, understanding, notice of changes etc. including certified copies of the acknowledgment, if any, evidencing filing of documents with the concerned authorities, if registered.

Clause 10(a): Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession).

Clause 10(b): If there is any change in the nature of business or profession, the particulars of such change.

Explanation for Clauses 10(a) and 10(b): In regard to the nature of business, the principal line of each business is to be determined and stated in this clause, i.e. the sector in which the business or profession falls such as manufacturing, trading, commission agent, builder, contractor, professionals, service sector, financial service sector or entertainment industry. In case of a person belongs to service sector the nature of each type of service should be broadly stated. Thereafter, the auditor is required to mention the sub-sector pertaining to the sector selected.

Information has to be furnished in respect of each business. The code to be mentioned against the nature of business pertains to the main area of business activity.

Any material change in the nature of business should be precisely set out. The change will include change from manufacturer to trader as well as change in the principal line of business.

A review of business report or the minutes of meetings would enable the tax auditor to note the changes, if any. Based thereon, he may make necessary enquiries and seek information and determine whether any change has occurred or not. If need be, the tax auditor should get a declaration from the assessee regarding change in the nature of business, if any.

In the case of restructuring, if any line of activity is being hived off, the same may also be reported.

The auditor should keep in mind the above guidance while furnishing information under this clause in the format provided for in the e-filing utility.

Clause 11(a): Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.

Clause 11(b): List of books of account maintained and the address at which the books of account are kept.

(In case books of account are maintained in a computer system, mention the books of account generated by such computer system. If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.)

Clause 11(c): List of books of account and nature of relevant documents examined.

Explanation for Clauses 11(a), 11(b), and 11(c): The CBDT under Rule 6F has prescribed the books of account and other documents to be kept and maintained by a person carrying on certain professions specified in sub-section (1) of section 44AA. As such, every person carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or authorised representative or film artist and whose total gross receipts exceed one lakh fifty thousand rupees in all the three years immediately preceding the previous year, or where the profession has been newly set up in the previous year, his total gross receipts in the profession for that year are likely to exceed the said amount, is required to maintain the following books of account:

1. Cash book.
2. Journal, if the accounts are maintained according to the mercantile system of accounting.
3. Ledger.

In the case of a person for whom the books of account have been prescribed under rule 6F, the list of books so prescribed have to be stated under clause 11(a). It may be noted that the daily case register and the inventory under broad heads do not constitute books of account and hence the same need not be mentioned under clause 11(a). Sometimes an assessee may carry on multiple activities. Books of account might have been prescribed for one of the activities. In that case, mention may be made of the activity for which books have been

15.25 Advanced Auditing and Professional Ethics

prescribed.

The tax auditor should obtain from the assessee a complete list of books of account and other documents maintained by him (both financial and non-financial records) and make appropriate marks of identification to ensure the identification of the books and records produced before him for audit. The list of books of account maintained by the assessee should be given under clause 11(b).

Section 44AA(2) provides that persons carrying on business or profession, other than those specified in sub-section (1), shall keep and maintain such books of account and other documents as may enable the Assessing Officer to compute his total income in accordance with the provisions of the Income-tax Act, if his income from business or profession exceeds the monetary limits prescribed under section 44AA(2) or his total sales, turnover or gross receipts in business or profession exceed the monetary limits prescribed under section 44AA(2) in any one of the three years immediately preceding the previous year. The tax auditor will, therefore, have to verify that the assessee has maintained such books of accounts and documents as may enable the Assessing Officer to compute the total income of the assessee in accordance with the provisions of the Act. It may be noted that though the Central Board of Direct Taxes has been empowered under sub-section (3) of section 44AA to prescribe books of account to be maintained under sub-section (2), so far no books of accounts have been prescribed.

For a person whose accounts of the business or profession have been audited under any other law, the requirement for maintenance of books of account is contained in the relevant statutes. In the case of other assessee, normal books of account to be maintained will be cash book/bank book, sales/purchase journal or register and ledger. Assessee engaged in trading/manufacturing activities should also maintain quantitative details of principal items of stores, raw materials and finished goods. While giving his report in Form No. 3CB about maintenance of proper books of account, the tax auditor should ensure that they are maintained in accordance with the above requirements. In case where stock records are not properly maintained by the assessee due to the nature, level, volume and variety of items/transactions, the tax auditor will have to consider the concept of materiality and practicality while giving particulars in Form No. 3CD.

In case, where books of accounts are maintained and generated through computer system, the auditor should obtain from the assessee the details of address of the place where the server is located or the principal place of business/Head office or registered office by whatever name called and mention the same accordingly in clause 11(b).

Clause 12: Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB Chapter XII-G, First Schedule or any other relevant section).

Where the profits and gains of the business are assessable to tax under presumptive basis under any of the sections mentioned below, the amount of such profits and gains credited/debited to the profit and loss account should be indicated under this clause:

S. No.	Section	Business covered
1	44AD	Eligible business
2	44AE	Transport business
3	44B	Shipping business of a non-resident
4	44BB	Providing service or facilities in connection with, or supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils
5	44BBA	Operation of aircraft by non-resident
6	44BBB	Civil construction etc. in certain turnkey power project by non-residents
7	Chapter XII-G	Special provisions relating to Shipping Companies (Section 115V to 115VT)
8	First Schedule	Insurance Business
9	Any other relevant section	This refers to the sections not listed above under which income may be assessable on presumptive basis like section 44D and section 115A(1)(b) and will include any other section that may be enacted in future for presumptive taxation

If the profit and loss account does not include profit assessable on presumptive basis, then, there is no requirement to furnish the particulars under this clause.

The amount to be mentioned under this clause means the amount included in the profit and loss account. The tax auditor is not required to indicate as to whether such amount corresponds to the amount assessable under the relevant section relating to presumptive taxation. As such, the reporting requirement gets satisfied if the amount as per profit and loss account is reported.

The auditor should keep in mind the prescribed guidance while furnishing information under this clause in the format provided in the e-filing utility.

Clause 13 (a) Method of accounting employed in the previous year.

Clause 13 (b) Whether there had been any change in the method of accounting employed vis-a-vis the method employed in the immediately preceding previous year.

Clause 13 (c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

Serial number	Particulars	Increase in profit (₹)	Decrease in profit (₹)

Clause 13 (d) Whether any adjustment is required to be made to the profits or loss for complying with the provisions of income computation and disclosure standards notified under section 145(2).

Clause 13 (e) If answer to (d) above is in the affirmative, give details of such adjustments:

15.27 Advanced Auditing and Professional Ethics

		<i>Increase in profit (₹)</i>	<i>Decrease in profit (₹)</i>	<i>Net effect (₹)</i>
<i>ICDS I</i>	<i>Accounting Policies</i>			
<i>ICDS II</i>	<i>Valuation of Inventories</i>			
<i>ICDS III</i>	<i>Construction Contracts</i>			
<i>ICDS IV</i>	<i>Revenue Recognition</i>			
<i>ICDS V</i>	<i>Tangible Fixed Assets</i>			
<i>ICDS VI</i>	<i>Changes in Foreign Exchange Rates</i>			
<i>ICDS VII</i>	<i>Governments Grants</i>			
<i>ICDS VIII</i>	<i>Securities</i>			
<i>ICDS IX</i>	<i>Borrowing Costs</i>			
<i>ICDS X</i>	<i>Provisions, Contingent Liabilities and Contingent Assets</i>			
	<i>Total</i>			

Clause 13 (f) Disclosure as per ICDS:

<i>(i)</i>	<i>ICDS I-Accounting Policies</i>
<i>(ii)</i>	<i>ICDS II-Valuation of Inventories</i>
<i>(iii)</i>	<i>ICDS III-Construction Contracts</i>
<i>(iv)</i>	<i>ICDS IV-Revenue Recognition</i>
<i>(v)</i>	<i>ICDS V-Tangible Fixed Assets</i>
<i>(vi)</i>	<i>ICDS VII-Governments Grants</i>
<i>(vii)</i>	<i>ICDS IX Borrowing Costs</i>
<i>(viii)</i>	<i>ICDS X-Provisions, Contingent Liabilities and Contingent Assets”.</i>

Explanation for Clauses 13(a), 13(b), 13(c) and 13(d): The Finance Act, 1995 amended section 145 with effect from assessment year 1997-98 to provide that the income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” must be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

Under sub-clause (b), whether there has been any change in the method of accounting employed vis-à-vis the method employed in the immediately preceding previous year is to be stated. As already noted, an assessee can follow either cash or mercantile system of accounting.

Under sub-clause (c), if there is any change, the effect thereof i.e. increase or decrease in profits has to be stated under this clause. So far as the question of effect of such change on

the profit or loss is concerned, the concept of materiality is the basic governing factor. If it is not possible to quantify the effect of the change in the method of accounting, appropriate disclosure should be made under this clause.

Under Clause (d), tax auditor has to report on whether any adjustment is required to be made to the profits or loss for complying with the provisions of income computation and disclosure standards notified under section 145(2).

The Finance (No. 2) Act, 2014 has amended section 145 w.e.f AY 2015-16 to the effect that the words 'accounting standards' be replaced with the words 'income computation and disclosure standards'. As per the memorandum, such an amendment has been made in order to clarify that the standards notified under section 145(2) are only meant for computation of income and disclosure of information and the assessee need not maintain books of account on the basis of AS notified under the Income-tax Act, 1961. The Accounting Standards issued by ICAI/ Companies Accounting Standard Rule, 2006 would still be required to be followed by the assessee, for preparation of financial statements.

Clause 14 (a) Method of valuation of closing stock employed in the previous year.

Clause 14 (b) Details of deviation, if any, from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish:

Serial number	Particulars	Increase in profit (₹)	Decrease in profit (₹)

Explanation for Clauses 14(a) and (b): The method of valuation of closing stock is to be stated under this clause. AS-2 "Valuation of Inventories" issued by ICAI requires disclosure of significant accounting policies. Accordingly, a reference may be invited to the same or the method of valuation may be again described in Form No.3CD.

In sub-clause (a) of clause 14 of Form No.3CD, the reference is made to "closing stock". The expression "stock-in-trade" means finished goods and raw materials. Since sub-clause (b) refers to section 145A where the term "inventories" is used, the term "closing stock" will include all items of inventories. AS-2 defines the term "inventories" to include finished goods, raw materials, work-in-progress, materials, maintenance supplies, consumables and loose tools. Therefore, method of valuation of items of inventories will have to be given under sub-clause (a).

The tax auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. He should obtain the inventory of closing stock, indicating the basis of valuation thereof, for reporting on the method of valuation of closing stock under this clause.

The method of stock valuation must be consistently followed from year to year and the method followed must be brought out clearly. The tax auditor should examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is necessary to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains. The Supreme Court in case of CIT v. British Paints Ltd. [1991] 188 ITR 44 (SC) has held that the method of valuation of stock at actual cost of raw materials and not taking into account

15.29 Advanced Auditing and Professional Ethics

overhead charges was not the correct method of valuation even though the said method has been consistently followed.

The details of deviation, if any, from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss have to be stated under clause 14(b).

Clause 15: Give the following particulars of the capital asset converted into stock-in-trade:-

- (a) Description of capital asset;**
- (b) Date of acquisition;**
- (c) Cost of acquisition;**
- (d) Amount at which the asset is converted into stock-in-trade.**

For furnishing the particulars required by clause 15, the provisions of section 2(47), 45(2), 47(iv), (v) and 47A have to be kept in mind.

The particulars to be stated under new clause 15 should be furnished with respect to the previous year in which the asset has been converted into stock-in-trade. The clause does not require details regarding the taxability of capital gains or business income arising from such deemed transfer.

Under clause (a) description of the capital asset is required to be mentioned for example shares, security, land, building, plant, machinery etc.

Under Clause (b) the date of acquisition is to be reported. For ascertaining the correct date the tax auditor will have to refer the accounts of the financial year in which such capital asset is acquired. The date assumes importance for the purpose of determining whether the asset is long-term or short-term in nature.

Under clause (c) the cost of acquisition is required to be reported. Here the cost of acquisition as per the books of account is to be mentioned. In case of depreciable assets, the carrying cost appearing in the books will be the written down value. But the value to be reported will be the original cost of acquisition. Even in case of an asset acquired prior to the 1st day of April, 1981 the value to be reported will be the original cost of acquisition. The assessee may exercise the option of considering the fair market value of the asset as on 1st April, 1981 for assets acquired prior to that date for the purpose of computation of capital gains as provided under section 55(2)(b)(i).

Under clause (d) the amount recorded in the books of account at which the asset is converted into stock-in-trade should be stated. Such an amount may not be the fair market value as on the date of conversion or treatment as stock-in-trade. If a value other than carrying cost is recorded then the auditor has to examine the basis of arriving at such a value. The valuation of stock-in-trade is to be examined with reference to AS-2 – Valuation of Inventories. Non-compliance with AS-2 is to be suitably qualified in the main audit report.

It is desirable that necessary accounting entry is passed in the books of account at the time of conversion of the asset into or treatment of the same as stock-in-trade.

Clause 16: Amounts not credited to the profit and loss account, being,-

- (a) the items falling within the scope of section 28;**
- (b) the proforma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax, where such credits, drawbacks or refunds are admitted as due by the authorities concerned;**
- (c) escalation claims accepted during the previous year;**
- (d) any other item of income;**
- (e) capital receipt, if any.**

Under this clause various amounts falling within the scope of section 28 which are not credited to the profit and loss account are to be stated. The information under sub-clauses (a), (d) and (e) of clause (16) is to be given with reference to the entries in the books of account and records made available to the tax auditor for the purpose of tax audit under section 44AB. Sub-clauses 16 (b), (c) & (d) require information in respect of items which may also be covered under section 28 and as such will also fall in clause 16 (a). However, those items which are reported in clauses 16(b), (c) and (d) need not be reported in clause 16 (a). The tax auditor may obtain a management representation in writing from the assessee in respect of all items falling under this clause.

The details of the following claims, if admitted as due by the concerned authorities but not credited to the profit and loss account, are to be stated under sub-clause (b).

- (i) Pro forma credits
- (ii) Drawback
- (iii) Refund of duty of customs
- (iv) Refund of excise duty
- (v) Refund of service tax
- (vi) Refund of sales tax or value added tax

In respect of items falling under sub-clause (b) the tax auditor should examine all relevant correspondence, records and evidence in order to determine whether any particular refund/claim has been admitted as due and accepted during the relevant financial year.

There may be practical difficulties in verifying the information in regard to such refunds and credits. It may, therefore, be necessary for the tax auditor to scrutinise the relevant files or subsequent records relating to such refunds while verifying the particulars and also obtain an appropriate management representation.

Under sub-clause (c), the escalation claims accepted during the previous year but not credited to the profit and loss account are to be stated. The escalation claims accepted during the year would normally mean "accepted during the relevant previous year". If such amount has not been credited to the profit and loss account the fact should be brought out. The system of accounting followed in respect of this particular item may also be brought out in appropriate cases. If the assessee is following cash basis of accounting with reference to this item, it

15.31 Advanced Auditing and Professional Ethics

should be clearly brought out since acceptance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed.

Sub-clause (d) covers any other items which the tax auditor considers as an income of the assessee based on his verification of records and other documents and information gathered, but which has not been credited to the profit and loss account. In giving the details under sub-clauses (c) and (d), due regard should be given to AS-9 - Revenue Recognition.

The tax auditor should scrutinise all the items including casual and nonrecurring items appearing in the books of account, particularly the credit items, and ensure himself whether any such credit which is in the nature of income has been credited to the profit and loss account or not.

Under sub-clause (e), capital receipt, if any, which has not been credited to the profit and loss account has to be stated. The tax auditor should use his professional expertise and judgement in determining whether the receipt is capital or revenue. The tax auditor may record various judicial pronouncements on which he has relied in his working papers.

The following is an illustrative list of capital receipts which, if not credited to the profit and loss account, are to be stated under this sub-clause.

- (a) Capital subsidy received in the form of Government grants which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For e.g. Capital Investment Subsidy Scheme.
- (b) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.
- (c) Compensation for surrendering certain rights.
- (d) Profit on sale of fixed assets/investments to the extent not credited to the profit and loss account.

If during the course of audit auditor finds that certain income (e.g. income referred to in section 41(1)) are not credited to profit and loss account, the particulars of the same along with the amount is required to be reported under this clause.

Clause 17: Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, please furnish:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, the auditor is required to furnish the following details:

- (a) Details of property
- (b) Consideration received or accrued
- (c) Value adopted or assessed or assessable

In the column requiring the details of property, the auditor has to furnish the details about the nature of property i.e. whether the property transferred by him is land or a building along with the address of such property. If the assessee has transferred more than one property, the detail of all such properties is required to be mentioned. The auditor should obtain a list of all properties transferred by the assessee during the previous year. He may also verify the same from the statement of profit and loss or balance sheet, as the case may be.

Under the heading “consideration received or accrued”, the auditor has to furnish the amount of consideration received or accrued, during the relevant previous year of audit, in respect of land/building transferred during the year as disclosed in the books of account of the assessee.

For reporting the value adopted or assessed or assessable, the auditor should obtain from the assessee a copy of the registered sale deed in case, the property is registered. In case the property is not registered, the auditor may verify relevant documents from relevant authorities or obtain third party expert like lawyer, solicitor representation to satisfy the compliance of section 43CA/ section 50C of the Act. In exceptional cases where the auditor is not able to obtain relevant documents, he may state the same through an observation in his report 3CA/CB.

Auditor would have to apply professional judgment as to what constitutes land or building for e.g. whether leasehold right / development rights / TDR / FSI etc would fall under this provisions or not, would require to be evaluated based on facts & circumstances of transactions.

Clause 18: Particulars of depreciation allowable as per the Income-tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form:-

- (a) **Description of asset/block of assets.**
- (b) **Rate of depreciation.**
- (c) **Actual cost or written down value, as the case may be.**
- (d) **Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –**
 - (i) **Central Value Added Tax credits claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,**
 - (ii) **change in rate of exchange of currency, and**
 - (iii) **subsidy or grant or reimbursement, by whatever name called.**
- (e) **Depreciation allowable.**
- (f) **Written down value at the end of the year.**

Having regard to the nature of requirements prescribed, it may be necessary for the tax

15.33 Advanced Auditing and Professional Ethics

auditor to examine:

- (a) Classification of the asset
- (b) Classification thereof to a block
- (c) The working of actual cost or written down value
- (d) The date of acquisition and the date on which it is put to use
- (e) The applicable rate of depreciation
- (f) The additions / deductions and dates thereof
- (g) Adjustments required – specified as well as on account of sale, etc.

For the purpose of determining the rate of depreciation, the tax auditor has to examine the classification of the assets into various blocks. The purpose for which the asset is used is also very material in this regard. Hence, the tax auditor should ensure that the classification as made by the assessee is in consonance with legal principles. In this connection, he should traverse through judicial pronouncements as well as through the past assessment history of the assessee, and upon an analysis thereof, if he comes to the conclusion that the matter is not free from doubt or controversy, he has to indicate the fact in his report by way of suitable qualification. It may also be necessary to rely upon technical data for determining the proper classification of the block. Since the tax auditor is not a technical expert, he has to obtain suitable certificate from concerned experts.

The tax auditor must have due regard to the Income-tax Rules, 1962, relevant clarifications from the Department and judicial decisions.

Under sub-clauses (a) to (b), information in respect of description of assets, block of assets under which the concerned asset is classifiable and the rate of depreciation are to be stated. This will include information about the existing assets. In respect of the existing assets, the computation of depreciation would involve stating the opening written down value of the block of assets which should be taken from the relevant income-tax records. The tax auditor will be conducting the audit in the current year only. As such the tax auditor can rely upon the classification of assets and written down value stated in the income tax records available with the assessee. The tax auditor should mention the fact that he has relied upon the income tax records of the assessee in respect of the information regarding the classification of assets and written down value of the existing assets.

For the purpose of determination of actual cost, the tax auditor has to be guided by the relevant legal provisions. Since determination of actual cost has got accounting implications, he can rely on the relevant Accounting Standards and Guidance Notes.

The additions/deductions during the year have to be reported, with dates. The tax auditor is advised to get the details of each asset or block of asset added during the year or disposed of during the year with the dates of acquisition/disposal. Where any addition was made, the date on which the asset was put to use is to be reported. In respect of deductions, the sale value of the assets disposed of along with dates should be mentioned. To ascertain when the asset has been put to use, the tax auditor could call for basic records like production

records/installation details/excise records/service tax records/records relating to power connection for operating the machine and any other relevant evidence.

Details have to be given in respect of adjustments on account of three factors. The first adjustment relates to CENVAT claimed and allowed under the Central Excise Rules, 1944 in respect of assets acquired on or after 1st March, 1994.

The second adjustment relates to the change in the rate of exchange of currency. Section 43A deals with the adjustment on account of change in the rate of exchange of currency.

The third adjustment relates to the subsidy or grant or reimbursement, by whatever name called. Explanation 10 to section 43(1) provides that where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee.

Finally, the amount of depreciation allowable and the WDV at the year end have to be stated. The tax auditor will need to verify the claim of additional depreciation under this clause as well.

Wherever, the full deduction of the cost of capital goods is allowed (e.g. expenditure on Scientific Research u/s. 35) the auditor should verify that the cost of such asset is not included in the block of assets for the purpose of depreciation.

Clause 19: Amounts admissible under sections:

Section	Amount debited to profit and loss account	Amounts admissible as per the provisions of the Income-tax Act, 1961 and also fulfills the conditions. If any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.
32AC 33AB 33ABA 35(1)(i) 35(1)(ii) 35(1)(ia) 35(1)(iii) 35(1)(iv) 35(2AA) 35(2AB) 35ABB 35AC		

15.35 Advanced Auditing and Professional Ethics

35AD		
35CCA		
35CCB		
35CCC		
35CCD		
35D		
35DD		
35DDA		
35E		

The assessee can claim deduction under the sections 32AC, 33AB, 33ABA, 35, 35ABB, 35AC, 35AD, 35CCA, 35CCB, 35CCC, 35CCD, 35D, 35DD, 35DDA and 35E subject to the terms and conditions mentioned in these Sections.

The Tax Auditor should indicate the amount debited to the Profit & Loss Account and the amount actually admissible in accordance with the applicable provisions of law.

The amount not debited to the Profit & Loss Account but admissible under any of the Sections mentioned in the clause have to be stated. For example, sections 33AB and 33ABA allow deduction in respect of amount deposited in designated account for specified purposes which, as per accounting principles, are not to be debited to the Profit & Loss Account. In this connection, the Tax Auditor has to work out, on the basis of the conditions prescribed in the concerned Section, the amount admissible there under and report the same.

An assessee may be eligible for deduction under one or more sub-sections of section 35. In such case, the Tax Auditor should state the deduction allowable under each sub-section separately under applicable part, i.e. the amount deductible in respect of the amount debited in Profit & Loss Account and the amount not debited to the Profit & Loss Account.

The Tax Auditor should also ensure the eligibility of the expenditure/payment for deduction and compliance of the conditions prescribed in the sub-section including approval from the relevant/prescribed authority, notification issued by the Central Government, any other guideline circular etc. issued in this behalf. Tax auditor should also refer Rule 6 of Income-tax Rules, 1962.

In case the auditor relies on a judicial pronouncement, he may mention the fact in his observations para provided in Form No.3CA or Form No.3CB, as the case may be.

Where under any section an assessee is eligible for deduction under one or more of the sub-sections of the said section, the Tax Auditor should certify the amount of deduction available under each sub-section separately in the applicable part, i.e. the amount deductible in respect of the amount debited to Profit & Loss Account and the amount not debited to the Profit & Loss Account.

Clause 20(a): Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)].

Clause 20(b): Details of contributions received from employees for various funds as referred to in section 36(1)(va):

Serial number	Nature of fund	Sum received from employees	Due date for payment	The actual amount paid	The actual date of payment to the concerned authorities

Explanation for Clauses 20(a) and (b): Section 36(1)(ii) provides for deduction of any sum paid to an employee as bonus or commission for services rendered where such sum would not have been payable to him as profit or dividend, if it had not been paid as bonus or commission. In other words, if bonus or commission is in the nature of profit or dividend, it may not be normally allowable as a deduction unless such payment is wholly and exclusively made to the employee. [Shahzada Nand & Sons v. CIT [1977]] 108 ITR 358 (SC).

Under Clause 20(b), the requirement is only in respect of the disclosure of the amount and the tax auditor is not expected to express his opinion about its allowability or otherwise. The tax auditor should verify the employment/ contract details of the employees so as to ascertain the nature of payments.

The tax auditor should get a list of various contributions recovered from the employees which come within the scope of this clause and the date on which it is deposited. He should also verify the documents relating to provident funds and other welfare funds. He should verify the agreement under which employees have to make contributions to provident fund and other welfare funds. The ledger account of contributions from employees should be reviewed; the due dates of payments and the actual dates of payment should be verified with the evidence available. In view of the voluminous nature of the information, the tax auditor can apply test checks and compliance tests to satisfy himself that the system of recovery and remittance is proper. Under this clause, details regarding the nature of fund, details of the amount deducted, due date for payment, actual amount paid and actual date of payment to the concerned authorities in respect of provident fund, ESI fund or other staff welfare fund have to be stated.

Clause 21(a): Please furnish the details of amounts debited to the profit and loss account, being in the nature of Capital, personal, advertisement expenditure etc.:

Nature	Serial number	Particulars	Amount in ₹
Capital Expenditure			
Personal Expenditure			

15.37 Advanced Auditing and Professional Ethics

Advertisement expenditure in any souvenir, brochure, tract, pamphlet or the like published by a political party			
Expenditure incurred at clubs being entrance fees and subscriptions			
Expenditure incurred at clubs being cost for club services and facilities used.			
Expenditure by way of penalty or fine for violation of any law for the time being force			
Expenditure by way of any other penalty or fine not covered above			
Expenditure incurred for any purpose which is an offence or which is prohibited by law			

Expenditure of Capital nature:

Capital expenditure is not allowable in computing business income unless specifically provided in any sections of the Act.

The details of capital expenditure, if any, debited to the profit and loss account should be maintained in a classified manner stating the amount under various heads separately. Since part of this capital expenditure may be allowable as deduction in the computation of total income, it is advisable to maintain particulars regarding the nature of expenditure, the amount of expenditure incurred, and the relevant provision under which the expenditure is admissible. However, the total amount of capital expenditure debited to the profit and loss account is to be reported under this clause in the e-filing portal.

Expenditure of personal nature:

Personal expenses debited to the profit and loss account are to be specified under this sub-clause as they are not deductible in the computation of total income under section 37.

Section 143(1)(e) of the Companies Act 2013 specifically requires the auditor to inquire whether personal expenses have been charged to revenue account. In the case of a person whose accounts of the business or profession have been audited under any other law, the tax auditor will have to report in respect of personal expenses debited in the profit and loss

account. In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the tax auditor will have to verify the personal expenses if debited in the expenses account while conducting the audit and verify the amount of expenses mentioned under this clause.

Expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party:

Section 37(2B) provides that no allowance shall be made in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party. Therefore, the expenditure of this nature should be segregated and reported under this clause.

The tax auditor may come across advertising expenditure incurred on advertising in a souvenir, brochure, tract, pamphlet or journal published by a trade union or a labour union formed by a political party. The trade union or labour union though promoted or formed by a political party may have a distinct legal entity.

Expenditure incurred at clubs being cost for club services and facilities used, entrance fees and subscriptions:

The amount of payments made to clubs by the assessee during the year being cost for club services and facilities used should be indicated under this clause. The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 21(a) referred to earlier. This clause requires reporting of particulars and the amount of such expenses incurred in the respective fields.

Expenditure by way of penalty or fine for violation of any law for the time being in force; Expenditure by way of penalty or fine not covered above; Expenditure incurred for any other purpose which is an offence or is prohibited by law:

This clause requires separate reporting of penalty or fine for violation of any law for the time being in force, and any other penalty or fine. The tax auditor should obtain in writing from the assessee the details of all payments by way of penalty or fine for violation of any laws have been made and paid or incurred during the relevant previous year and how such amounts have been dealt with in the books of accounts produced for audit.

In order to ascertain the facts whether the sum debited in the profit and loss account is by way of penalty or fine for any violation of law, the tax auditor will have to refer to the relevant law under which the amount has been paid or incurred and ascertain whether such amount is in the nature of penalty or fine.

Clause 21(b): Amounts inadmissible under section 40(a):

(i) as payment to non-resident referred to in sub-clause (i)

(A) Details of payment on which tax is not deducted:

- (I) date of payment
- (II) amount of payment
- (III) nature of payment
- (IV) name and address of the payee
- (B) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)
 - (I) date of payment
 - (II) amount of payment
 - (III) nature of payment
 - (IV) name and address of the payee
 - (V) amount of tax deducted
- (ii) as payment referred to in sub-clause (ia)
 - (A) Details of payment on which tax is not deducted:
 - (I) Date of payment
 - (II) Amount of payment
 - (III) Nature of payment
 - (IV) Name and address of the payee
 - (B) Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub-section (1) of section 139.
 - (I) Date of payment
 - (II) Amount of payment
 - (III) Nature of payment
 - (IV) Name and address of the payer*
 - (V) Amount of tax deducted
 - (VI) Amount out of (V) deposited, if any
- (iii) Under sub-clause (ic) [wherever applicable]
- (iv) Under sub-clause (iia)
- (v) Under sub-clause (iib)
- (vi) Under sub-clause (iii)
 - (A) Date of payment
 - (B) Amount of payment
 - (C) Name and address of the payee
- (vii) Under sub-clause (iv)

(viii) Under sub-clause (v)

***should be read as “payee” for proper reporting.**

This clause is substantially expanded to furnish detailed information for deduction and deposit of TDS. Section 40(a) specifies certain amounts which shall not be deducted in computing the income chargeable under the head “Profits and gains of business or profession”. In case where the assessee submits that any sum debited to profit and loss account is not inadmissible under the provisions of sub-section (a) of section 40, the tax auditor may exercise his judgement in the light of the applicable laws and report accordingly about the compliance of this provision. The tax auditor may rely upon the judicial pronouncements while taking any particular view. In case of difference of opinion between the tax auditor and the assessee, the tax auditor should state both the view points. In case of voluminous nature of the information, the tax auditor can apply materiality principles, tests checks and compliance tests for verifying the information required to be provided under this clause.

Clause 21(c): Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof.

The tax auditor is required to state the inadmissible amount under section 40(b)/40(ba) and such information is also required to be given in respect of interest/ remuneration paid to a member of an Association of persons (AOP)/Body of individuals (BOI). By Finance Act (No.2) 2009, w.e.f. 1.4.2010, the term firm includes LLP (as registered under the provisions of LLP Act, 2008) The word "inadmissible" implies that the tax auditor will have to examine the facts, apply the conditions for allowance or disallowance and accordingly determine the prima facie inadmissibility of the deduction and also quantify the same.

In order to determine the amounts inadmissible under section 40(b), the tax auditor should obtain the computation of total income from the assessee.

The tax auditor should maintain the information in the prescribed format as a part of his working papers and report appropriately in the format provided in the e-filing utility. The tax auditor may note that the information required to be reported is the amount of inadmissible expenditure as per section 40(b) or 40(ba) and not the total amount debited to profit and loss account.

Clause 21(d): Disallowance/deemed income under section 40A(3).

(A) On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:

Serial Number	Date of Payment	Nature of Payment	Amount	Name and Permanent Account Number of the payee, if available

(B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule

15.41 Advanced Auditing and Professional Ethics

6DD were made by account payee cheque drawn on a bank or account payee bank draft
If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A):

Serial Number	Date of Payment	Nature of Payment	Amount	Name and Permanent Account Number of the payee, if available

For the purpose of furnishing the above particulars, the tax auditor should obtain a list of all cash payments in respect of expenditure exceeding ₹ 20,000 (₹ 35000/- in case of plying, hiring or leasing goods carriages w.e.f. 1.10.2009) made by the assessee during the relevant year which should include the list of payments exempted in terms of Rule 6DD with reasons. This list should be verified by the tax auditor with the books of account in order to ascertain whether the conditions for specific exemption granted under clauses (a) to (l) of Rule 6DD are satisfied. Details of payments which do not satisfy the above conditions should be stated under this clause.

The tax auditor has to take into account the technological advancements in the field of banking and information technology where payments have been taken other than through an account payee cheque or bank draft.

Clause 21(e): provision for payment of gratuity not allowable under section 40A(7).

As per section 40A(7), the deduction shall be allowed in relation to any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year.

The tax auditor should call for the order of the Commissioner of Income-tax granting approval to the gratuity fund, verify the date from which it is effective and also verify whether the provision has been made as provided in the trust deed.

In case the provision made for payment of gratuity is not allowable under section 40A(7), the same is to be stated under this sub-clause.

Clause 21(f): any sum paid by the assessee as an employer not allowable under section 40A(9).

Under section 40A(9) any payment made by an employer towards the setting up or formation of or as contribution to any fund, trust, company, association of persons, body of individuals, society registered under the Societies Registration Act, 1860, or other institutions (other than contributions to recognised provident fund or approved superannuation fund or notified pension scheme or approved gratuity fund) is not allowable. The tax auditor should furnish the details of payments which are not allowable under this section.

Clause 21(g): particulars of any liability of a contingent nature.

The assessee is required to furnish particulars of any liability of a contingent nature debited to the profit and loss account. The tax auditor may not be able to immediately ascertain the details of contingent liabilities debited to the profit and loss account without a detailed scrutiny

of various account heads e.g. outstanding liabilities, provision etc. Accounting policy followed and disclosed would be helpful in ascertaining and verifying details. The expenses relating to disputed claims will be revealed only on the basis of the scrutiny of records relating to contingent liabilities. The tax auditor may look into particular items of contingent liabilities of the earlier year in order to determine whether or not any items has been charged to the profit and loss account of the current year and if so, whether the liability continues to be contingent in nature. Wherever necessary, a suitable note should be given by the tax auditor as to the non-availability of such particulars relating to the contingent liabilities.

Clause 21(h): Amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income.

The tax auditor shall examine the details of amount of inadmissible expenditure as furnished by the assessee. While carrying out such examination the tax auditor is entitled to rely on the management representation. However, Standard on Auditing (SA) 580, "Written Representations" may be referred to.

The tax auditor will verify the amount of inadmissible expenditure as estimated by the assessee with reference to established principles of allocation of expenditure based on logical parameters like proportion of exempt and taxable income recorded, turnover, man hours spent to earn the relevant income etc. For allocation of interest between taxable and non-taxable income, the quantum of investment, the period and the rate of interest are generally the relevant factors to be considered. This requires proper estimates to be made by the assessee. The tax auditor is required to audit such estimates. Attention is invited to Standard on Auditing - 540 "Audit of Accounting Estimates, including Fair value Accounting Estimates and Related Disclosures".

An assessee may claim that no expenditure has been incurred by him in relation to income which does not form part of the total income under the Act. Even in such a case the provisions of section 14A will apply. Accordingly, the tax auditor is required to verify such contention of the assessee.

Clause 21(i): amount inadmissible under the proviso to section 36(1)(iii).

The provisions of section 36(1)(iii) provide that the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession would be allowed as a deduction in computing the income referred to in section 28 of the Act.

The proviso thereunder (inserted by the Finance Act, 2003 w.e.f. A.Y. 2004-05) provides that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books or account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was put to use, shall not be allowed as a deduction.

The extension of an existing business or profession is a fact based exercise and the tax auditor should apply the professional judgment in determining the applicability of the proviso.

15.43 Advanced Auditing and Professional Ethics

The tax auditor is also advised to verify the treatment given for such asset under other provision of the Act like Chapter VI A deductions or under other statutes.

The tax auditor has to verify the correctness of the particulars furnished by the assessee with the documentary evidence.

Clause 22: Amount inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

This clause was inserted by the Central Board of Direct Taxes through its Notification No. 36/2009 dated 13-4-2009, in the Form No.3CD in Appendix II of the Income-tax Rules, 1962.

The tax auditor is required to state the amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. The Micro, Small and Medium Enterprises Development Act, 2006 (MSME Act) is an Act to provide for facilitating the promotion and development and enhancing the competitiveness of micro, small and medium enterprises and for matters connected therewith or incidental thereto.

Section 23 of the MSME Act lays down that an interest payable or paid by the buyer, under or in accordance with the provisions of this Act, shall not for the purposes of the computation of income under the Income-tax Act, 1961 be allowed as a deduction.

The inadmissible interest has to be determined on the basis of the provisions of the MSME Act.

The tax auditor while reporting in respect of clause 22 should take the following steps:

- (a) The auditor should seek information regarding status of the enterprise i.e. whether the same is covered under the Micro, Small and Medium Enterprises Development Act, 2006. Where the information is available and has been disclosed the same should be reported as such in Form No. 3CD. Where the information is not available the auditor should also mention the same in the Form No.3CD.
- (b) Since Section 22 of the Micro, Small and Medium Enterprises Development Act, 2006 requires disclosure of information, the tax auditor should cross check the disclosure made in the financial statements.
- (c) Obtain a full list of suppliers of the assessee which fall within the purview of the definition of "Supplier" under section 2(n) of the Micro, Small and Medium Enterprises Development Act, 2006. It is the responsibility of the auditee to classify and identify those suppliers who are covered by this Act.
- (d) Review the list so obtained.
- (e) Verify from the books of account whether any interest payable or paid to the buyer in terms of section 16 of the MSME Act has been debited or provided for in the books of account.
- (f) Verify the interest payable or paid as mentioned above on test check basis.
- (g) Verify the additional information provided by the auditee relating to interest under section 16 in his financial statement.

- (h) If on test check basis, the auditor is satisfied, then the amount so debited to the profit and loss account should be reported under clause 22.

Where the tax auditor, upon due verification, finds that the auditee has neither provided for nor paid any interest payable under the MSME Act, the no amount is inadmissible under section 23 of MSME Act. In such a case, appropriate reporting should be made against this clause in the format provided in the e-filing utility.

Clause 23: Particulars of payments made to persons specified under section 40A(2)(b).

Section 40(A)(2) provides that expenditure for which payment has been or is to be made to certain specified persons listed in the section may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or unreasonable having regard to:

- (i) the fair market value of the goods, services or facilities for which the payment is made; or
- (ii) for the legitimate needs of business or profession of the assessee; or
- (iii) the benefit derived by or accruing to the assessee from such expenditure.

Further, proviso to section 40A(2)(a) provides that no disallowance on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.

The section enjoins on the Assessing Officer the power to fix the quantum of disallowance. Under this clause, the particulars of payments coming under this sub-section are to be stated. The following steps may be taken by the tax auditor in this connection:

- (a) Obtain full list of specified persons as contemplated in this section.
- (b) Obtain details of expenditure/payments made to the specified persons.
- (c) Scrutinise all items of expenditure/payments to the above persons.
- (d) It may be difficult to locate all such payments and it may also involve a time consuming effort. It is, however, possible to localise the area of enquiry.

Clause 24: Amounts deemed to be profits and gains under section 32AC, 33AB or 33ABA or 33AC.

Section 32AC allows deduction @ 15% in respect of Investment in new Plant & Machinery to a company who is engaged in the business of manufacture or production of any article or thing and who acquires and installs new asset after the 31st day of March, 2013 but before the 1st day of April, 2015 and the aggregate actual cost of such new assets exceeds one hundred crore rupees. The Finance Act, 2014 has amended section 32AC w.e.f. financial year 2014-15. The investment limit in the plant and machinery has been reduced to ₹ 25 crores from ₹ 100 crores. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections (2) of section 32AC. Only because section 32AC(2) provides for chargeability of deemed income under the head "profit and gains from business or profession" in addition to taxability of capital gains, the auditor is not required to report any capital gains/losses arising on transfer on the said asset. The tax auditor will be required to verify the compliance to the conditions of the provisions of section 32AC and report

15.45 Advanced Auditing and Professional Ethics

the claim of deduction accordingly.

Clause 25: Any amount of profit chargeable to tax under section 41 and computation thereof.

The tax auditor should obtain a list containing all the amounts chargeable under section 41 with the accompanying evidence, correspondence, etc. He should in all relevant cases examine the past records to satisfy himself about the correctness of the information provided by the assessee. The tax auditor has to state the profit chargeable to tax under this section. This information has to be given irrespective of the fact whether the relevant amount has been credited to the profit and loss account or not. The computation of the profit chargeable under this clause is also to be stated.

The tax auditor should maintain the following in his working papers for the purpose of furnishing details required in the format provided in the e-filing utility:

Sr. No.	Name of person	Amount of income	Section	Description of transaction	Computation if any
1	2	3	4	5	6

Clause 26: In respect of any sum referred to in clause (a), (b), (c), (d), (e) or (f) of section 43B, the liability for which:-

- (A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was**
- (a) paid during the previous year;**
 - (b) not paid during the previous year;**
- (B) was incurred in the previous year and was**
- (a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);**
 - (b) not paid on or before the aforesaid date.**

(State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost etc. is passed through the profit and loss account.)

In the case of an assessee maintaining its accounts on the mercantile system, the tax auditor should verify the aforesaid particulars of section 43B from the books of account for the year under audit as well as from the books of account, vouchers and documents of the immediately succeeding assessment year as well as return of income for the earlier assessment years so that the information about the aforesaid payments made in the subsequent year can be furnished.

The tax auditor, in his tax audit report, should clearly distinguish the liability incurred during the previous year in respect of all the specified sums referred to in clauses (a) to (f) from the liability that pre-existed on the first day of the relevant previous year.

In some cases the tax auditor may find amounts of the nature referred to in section 43B being credited to the profit and loss account although the relevant provisions for such liability had

not been allowed as a deduction in any previous year in view of the specific provisions of section 43B requiring actual payment as a condition precedent to allowance. The amounts so credited to the profit and loss account are not chargeable to tax since the conditions referred to in section 41(1) have not been satisfied. The tax auditor should identify such items and maintain the same in his working papers.

Clause 27(a): Amount of Central Value Added Tax credits availed of or utilized during the previous year and its treatment in the profit and loss account and treatment of outstanding Central Value Added Tax credits in the accounts.

CENVAT credit is available on eligible inputs, input services and capital goods. Such credits are utilized for the payment of the excise duty and service tax liability. Accordingly the tax auditor should check relevant statutory records maintained under the Central Excise Rules, 2002 and the records maintained under CENVAT Credit Rules, 2004 and ascertain therefrom the amount of credit on eligible inputs, input services and the capital goods and the amount utilised during the previous year. Records maintained in RG-23, wherever available should also be verified.

The tax auditor should verify that there is a proper reconciliation between balance of CENVAT credit in the accounts and relevant excise and service tax records. The tax auditor should report the amount of CENVAT availed and utilised under this sub-clause. In a given case CENVAT availed may be lesser than the CENVAT credit utilised during the year on account of opening balance in CENVAT account or vice-versa and as such it would be advisable, in order to avoid any misleading conclusion and inferences, to report the opening and closing balances of CENVAT. Further the sub-clause requires reporting of the credits availed of or utilized during the previous year, it is desirable to report both the credits availed and the credits utilized.

In so far as the reporting of accounting treatment of CENVAT credit is concerned the clause requires that its treatment in profit and loss account and the treatment of outstanding CENVAT credit in the account have to be reported upon.

The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

CENVAT	Amount	Treatment in Profit & Loss Accounts
Opening balance		
CENVAT Availed		
CENVAT utilized		
Closing / outstanding Balance		

Clause 27(b): Particulars of income or expenditure of prior period credited or debited to the profit and loss account.

It may be noted that information under this clause would be relevant only in those cases where the assessee follows mercantile system of accounting. Under cash system of

15.47 Advanced Auditing and Professional Ethics

accounting, expenses debited/ income credited to the profit and loss account would be current year's expenses/income even though they may relate to earlier years. The tax auditor should obtain the particulars of expenditure or income of any earlier year debited or credited to the profit and loss account of the relevant previous year when mercantile system of accounting is followed. In the case of a person whose accounts of the business or profession have been audited under any other law, the information may be available from annual accounts. In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, however, a close scrutiny of the ledger in regard to the period for which expenditure or income is entered in the account books may be necessary.

The tax auditor should maintain the following information in his working papers file for the purpose of reporting in the format provided in the e-filing utility:

Sr. No.	Type	Particulars	Amount	Prior Period to which it relates (Year in yyyy-yy format)
1	2	3	4	5

Clause 28: Whether during the previous year the assessee has received any property, being share of a company not being a company in which the public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viia), if yes, please furnish the details of the same.

Section 56(2)(viia) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company (not being a company in which the public is substantially interested,

- (i) without consideration, the aggregate fair value of which exceeds rupees fifty thousand, the whole of the aggregate fair market value of such property
- (ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration

shall be chargeable to income-tax under the head "Income from other sources"

Section 56(2)(viia) does not apply to the property received by way of a transaction not regarded as transfer under section 47(via), 47(vic), 47(vicb), 47(vid) and 47(vii). The fair market value of shares means the value determined in accordance with the method prescribed in rule 11UA of the Income-tax Rules, 1962.

Since section 56(2)(viia) is applicable to firms and companies in which public is not substantially interested, reporting under this clause is required only for them and not for other assesseees. The auditor should obtain from the auditee, a list containing the details of shares received, if any, by him from any other company and verify the same from the books of accounts and other relevant documents. Such shares, if received will be reflected in the books of accounts either as investments or as stock in trade. In case such shares are received without consideration, the same may not be reflected in the books of accounts. Such shares

may be verified from the relevant documents such as share certificates issued, if any, demat account statement etc. In either case, the same have to be reported under this clause.

For reporting under this clause, the auditor has to consider the provisions of Rule 11UA(1)(c) which provides for manner of determining:

- (a) fair market value of quoted shares and securities received by way of transaction carried out through any recognized stock exchange
- (b) fair market value of quoted shares and securities received by way of transaction carried out OTHER THAN through any recognized stock exchange
- (c) fair market value of unquoted equity shares
- (d) fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange

Where for determining the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange, a valuation report has been obtained by the assessee from a merchant banker or an accountant, the auditor should obtain a copy of the same. Here, attention is invited to the Standard on Auditing- 620 "Using the work of an Auditor's expert".

Clause 29: Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same.

Section 56(2)(viib) provides that where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head "Income from other sources".

The provisions of this clause are not applicable where the consideration is received:

- (a) by a venture capital undertaking from a venture capital company or a venture capital fund
- (b) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

As per the explanation to section 56(2)(viib), the fair market value shall be the value as may be determined in accordance with such method as prescribed under Rule 11UA or as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher.

Since section 56(2)(viib) is applicable to companies in which public is not substantially interested, reporting under this clause is to be done only for corporate assesseees. The auditor should obtain from the auditee, a list containing the details of shares issued, if any, by him to any person being a resident and verify the same from the books of accounts and other

15.49 Advanced Auditing and Professional Ethics

relevant documents. Attention is invited to the provisions of section 2(18) which defines the company in which public are substantially interested.

For reporting under this clause with respect to quoted shares, the auditor has to consider the provisions of Rule 11UA(1)(c)(a) which provides for manner of determining:

- (a) fair market value of quoted shares and securities received by way of transaction carried out through any recognized stock exchange
- (b) fair market value of quoted shares and securities received by way of transaction carried out OTHER THAN through any recognized stock exchange

For reporting under this clause with respect to unquoted equity shares, the auditor has to consider the provisions of Rule 11UA(2) which provides for manner of determining the fair market value of unquoted equity shares.

Clause 30: Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. [Section 69D].

Details of the amount borrowed on hundi (including interest on such amount borrowed) and details of repayment otherwise than by an account payee cheque, are required to be indicated under this clause.

For this purpose, the tax auditor should obtain a complete list of borrowings and repayments of hundi loans otherwise than by account payee cheques and verify the same with the books of account.

Clause 31 (a)* Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year:-

- (i) name, address and permanent account number (if available with the assessee) of the lender or depositor;
- (ii) amount of loan or deposit taken or accepted;
- (iii) whether the loan or deposit was squared up during the previous year;
- (iv) maximum amount outstanding in the account at any time during the previous year;
- (v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

***(These particulars need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)**

Section 269SS prescribes the mode of taking or accepting certain loans and deposits. As per this section, no person shall take or accept from any other person any loan or deposit otherwise than by an account payee cheque or account payee bank draft if,-

- (a) the amount of such loan or deposit or the aggregate amount of such loan and deposit; or
- (b) on the date of taking or accepting such loan or deposit, any loan or deposit taken or accepted earlier by such person from the depositor is remaining unpaid (whether

repayment has fallen due or not), the amount or the aggregate amount remaining unpaid;
or

- (c) the amount or the aggregate amount referred to in clause (a) together with the amount or the aggregate amount referred to in clause (b),

is twenty thousand rupees or more.

For the purposes of section 269SS "loan or deposit" means loan or deposit of money.

If the total of all loans/deposits from a person exceed ₹ 20,000/- but each individual item is less than ₹ 20,000/-, the information will still be required to be given in respect of all such entries starting from the entry when the balance reaches ₹ 20,000/- or more and until the balance goes down below ₹ 20,000/-. As such the tax auditor should verify all loans/deposits taken or accepted where balance has reached ₹ 20,000 or more during the year for the purpose of reporting under this clause.

The tax auditor has to take into account the technological advancements in the field of banking and information technology where loans have been taken other than through an account payee cheque or bank draft which are capable of being tracked such as bank transactions made electronically through the internet or through mail transfer or telegraphic transfer. These types of payments, though not made by account payee cheques in the conventional manner are capable of being tracked. In order to judicially apply the provisions of section 269SS, the tax auditor need not report such cases under this clause. The Finance (No.2) Act, 2014 has acknowledged the fact and allowed the "use of electronic clearing system through a bank account" as a permissible mode for the purposes of section 269SS .

As per the proviso to section 269SS, the provisions of section 269SS shall not apply to any loan or deposit taken or accepted from, or any loan or deposit taken or accepted by-

- (a) Government;
- (b) any banking company, post office savings bank or co-operative bank;
- (c) any corporation established by a Central, State or Provincial Act;
- (d) any Government company as defined in section 2(45) of the Companies Act, 2013; Section 617 of the Companies Act, 1956 has been replaced with section 2(45) in the Companies Act, 2013 with effect from 1.4.2014.
- (e) such other institution, association or body or class of institutions, associations or bodies which the Central Government may, for reasons to be recorded in writing, notify in this behalf in the Official Gazette.

The auditor should maintain the prescribed information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility. These particulars need not be given in case of a Government Company, a banking company or a corporation established by a Central, State or Provincial Act.

Clause 31(b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year:-

15.51 Advanced Auditing and Professional Ethics

- (i) name, address and permanent account number (if available with the assessee) of the payee;
- (ii) amount of the repayment;
- (iii) maximum amount outstanding in the account at any time during the previous year;
- (iv) whether the repayment was made otherwise than by account payee cheque or account payee bank draft.

(The particulars (i) to (iv) above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act.)

This sub-clause requires particulars of each repayment of loan or deposit in an amount exceeding the limits specified in section 269T made during the previous year. Section 269T after amendment by the Finance Act, 2002 w.e.f. 1.6.2002 is now applicable to repayment of both loans and deposits. Section 269T is attracted where repayment of the loan or deposit is made to a person, where the aggregate amount of loans or deposits held by such person either in his own name or jointly with any other person on the date of such repayment together with interest, if any, payable on such deposit is ₹ 20,000 or more. Explanation (iii) contains a definition of the term “loan or deposit” for the purposes of section 269T. Accordingly, “loan or deposit” means any deposit of money which is repayable after notice or repayable after a period and, in the case of a person other than a company, includes loan or deposit of any nature. As such, all repayments made to any person where the loan or deposit along with interest is ₹ 20,000 or more are to be reported under this sub-clause, even though the amount of repayment may be less than ₹ 20,000. The tax auditor should verify such repayments and report accordingly.

The second proviso to section 269T inserted by the Finance Act, 2003 w.e.f. 1.6.2002 excludes repayments of loans taken from Government, Government company, Banking company, Corporation established by a Central, State or Provincial Act etc from the scope of the above section and therefore the tax auditor need not report such repayments in his report. However, section 269T does not exclude Government companies, banking companies from the scope of its applicability. As such, details of repayment are to be shown in the case of these entities also.

The monetary limit of ₹ 20,000 or more is applicable in respect of a banking company or a cooperative bank with reference to each branch and in all other cases assessee as a whole.

The auditor should maintain the prescribed information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

Clause 31(c) Whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents

(The comment above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act.)

Under this sub clause the tax auditor has to comment as to whether the taking or accepting loan or deposit, or repayment of the same through an account payee cheque or an account payee bank draft based on the examination of books of accounts & other relevant documents.

In the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act, the particulars (i) to (iv) mentioned in sub-clause (b) of clause 31 and also the comment mentioned above need not be given.

However, section 269T does not exclude loans repaid by Government companies, banking companies, corporation established by a Central, State or Provincial Act from the scope of its applicability. As such, details of repayment made by such entities are to be shown.

It may be noted that the new requirement should be made applicable for the loans and the advances which are in excess of ₹ 20,000/-. This is evident from a harmonious reading of the clause (c) with the clauses (a) and (b).

Clause 32(a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available:

SI No.	Assessment year	Nature of loss / allowance (in rupees)	Amount as returned (in rupees)	Amount as assessed (give reference to relevant order)	Remarks

The amount of brought forward loss or depreciation allowance is required to be quantified as per return and assessment orders. A reporting format is prescribed for the sake of standardization.

At times while the particular claim for loss/allowance pertains to a particular assessment year as per the return of income, the same may relate to another assessment year as per the assessment order, e.g., depreciation claim in respect of assets capitalized at the end of the financial year. In those cases, once the assessment order is received, the particulars have to be re-stated with reference to the assessment year to which they relate as per the assessment order. This should be accompanied by suitable explanation in the remarks column.

The e-filing utility may require additional information regarding the relevant order. The information is required to be disclosed to the extent available. The tax auditor should consider the above guidance for the purpose of reporting under this clause in the format provided in the e-filing utility.

Clause 32(b) whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.

Section 79 of the Act provides that, notwithstanding anything contained in Chapter VI of the Act, in the case of a company, not being a company in which the public are substantially interested, where a change in shareholding has taken place in a previous year, then no loss incurred in any year prior to the previous year shall be carried forward and set off against the

15.53 Advanced Auditing and Professional Ethics

income of the previous year unless on the last day of that previous year and on the last day of the previous year in which the loss was incurred, the shares of the company carrying not less than 51% of the voting power were beneficially held by the same persons.

Clause 32(c) whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, if yes, please furnish the details of the same.

Section 73 of the Act provides for the treatment of losses in speculation business. Section 73(1) provides that any loss, computed in respect of a speculation business carried on by the assessee, shall not be set off except against profits and gains, if any, of another speculation business.

The tax auditor should maintain the prescribed information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

Clause 32(d) whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same.

Section 73A provides for provisions relating to carry forward and set off of losses by specified business. It provides that any loss, computed in respect of any specified business referred to in section 35AD shall not be set off except against profits and gains, if any, of any other specified business.

Under clause 32(d), the tax auditor has to verify from the books of accounts and other relevant documents as to whether the assessee is carrying on specified business as referred to under section 35AD. In case the auditor is of the opinion that the assessee is carrying on such specified business, he has to furnish the details of the loss incurred, if any, in respect of any specified business during the previous year. In case the assessee carries on more than one specified businesses and loss has been incurred in both the business, the details of the loss incurred with respect of each business is to be specified separately.

The tax auditor should maintain the prescribed information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

Clause 32(e) In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year.

The Explanation to section 73 provides that where any part of the business of a company (other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources" or a company the principal business of which is the business of trading in shares or banking or the granting of loans and advances) consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares. The Finance Act, 2014 has amended the explanation to section 73 by deleting the words "the principal business of which is the business of trading in shares" from financial year 2014-2015.

Under this clause, the tax auditor has to furnish the details regarding the speculation losses incurred, if any, as referred in explanation to section 73. The auditor may obtain information in the following format from the assessee and verify the same from the books of account, income tax returns of earlier years and other relevant documents.

The prescribed information so maintained may be used by the tax auditor for the purpose of reporting against this clause in the format provided in the e-filing utility.

Clause 33: Section-wise details of deductions, if any, admissible under Chapter VIA or Chapter III (Section 10A, Section 10AA).

Section under which deduction is claimed	Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.

Chapter VIA of the Act deals with various deductions which have to be given effect to by way of allowance from gross total Income of the assessee and they have been categorised under the Act as follows:

- A. Deduction in respect of certain payments.
- B. Deduction in respect of certain incomes.
- C. Other Deductions.

While Chapter III relates to Income which do not form part of total income, the reporting under this clause is required only with respect to exemptions claimed under section 10A (Special provisions in respect of newly established undertakings in free trade Zone etc) and section 10AA (Special provisions in respect of newly established units in Special Economic Zones).

Some sections in Chapter VIA such as section 80-G (donations), Section 80-GGB/80-GGC (contributions to political parties), section 80-JJAA (wages of new workmen) etc. relate to the expenditure incurred by an assessee. There are other sections such as section 80-P (income of co-operative societies), 80-JJA (certain specified business relating treatment of biodegradable waste) etc. which relate to income of the assessee. In respect of all these sections the tax auditor should ascertain whether there is any expenditure or income covered by the above sections recorded in the books of accounts audited by him. Information with regard to such expenditure/income in respect of deduction allowable under Chapter VIA should be given on the basis of the examination of the books of account and other records under clause 33.

Clause 34 (a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:

15.55 Advanced Auditing and Professional Ethics

Tax deduction and collection Account Number (TAN)	Section	Nature of payment	Total amount of payment or receipt of the nature specified in column (3)	Total amount on which tax was required to be deducted or collected out of (4)	Total amount on which tax was deducted or collected at specified rate out of (5)	Amount of tax deducted or collected out of (6)	Total amount on which tax was deducted or collected at less than specified rate out of (7)*	Amount of tax deducted or collected on (8)	Amount of tax deducted or collected not deposited to the credit of the Central Government out of ** (6) and *** (8)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

*Should be read as (5) for proper reporting

** Should be read as (7) for proper reporting

*** Should be read as (9) for proper reporting

While reporting under this clause the tax auditor may exercise his judgement in the light of the applicable laws and report accordingly about the applicability of the provisions of Chapter XVII-B or XVII-BB with regard to the auditee. The tax auditor may rely upon the judicial pronouncements while taking any particular view.

The auditor should obtain a copy of the TDS/TCS returns filed by the assessee which shall form the basis of reporting under this clause, to the extent possible. Further, in view of the voluminous nature of the transactions, the tax auditor can apply test checks and compliance tests on the transactions reported in the TDS return by the assessee for verifying the information required to be provided under this clause.

Clause 34 (b) Whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details:

Tax deduction and collection Account Number (TAN)	Type of Form	Due date for furnishing	Date of furnishing, if furnished	Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported

Under clause 34(b), the tax auditor has to ascertain and report as to whether the assessee has furnished the statement of tax deducted or tax collected at source within the prescribed time.

Clause 34(b) also requires the auditor to report the transactions with regard to each TAN for which tax has been deducted but the return has either not been filed or has been filed after the expiry of the prescribed time. With regard to each TAN, the auditor is required to mention the "Type of form" that was applicable like Form 24, 24G, 24Q, 26, 26A, 26B, 26Q etc, due date of furnishing such statement and the actual date of furnishing, if the statement(s) has been furnished. Lastly, the auditor is required to state as to whether the statement of tax deducted or collected, which has been furnished beyond prescribed time contains information about all the transactions which are required to be reported.

Clause 34 (c) whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish:

Tax deduction and collection Account Number (TAN)	Amount of interest under section 201(1A)/206C(7) is payable	Amount paid out of column (2) along with date of payment.

Under this clause, the auditor is required to furnish detailed information in case the assessee is liable to pay interest under section 201(1A) or section 206C(7) of the Act. Section 201(1A) provides for payment of interest at a specified rate in case the tax has not been deducted wholly or partly or after deducting has not been paid to the credit of Central Government as required by the Act. Similarly, section 206C(7) provides for payment of interest at a specified rate in case the tax is not collected wholly or partly or if collected not paid to the credit of the Central Government as required by the Act. The reporting as to whether the assessee is liable to pay such interest, should be in consonance with the reporting under clause 34(a) where the details of non-deduction are required to be reported by him.

Clause 35 (a) In the case of a trading concern, give quantitative details of the principal items of goods traded:

- (i) Opening stock;
- (ii) Purchases during the previous year;
- (iii) Sales during the previous year;
- (iv) Closing stock;
- (v) shortage / excess, if any.

The tax auditor should obtain certificates from the assessee in respect of the principal items of goods traded, the balance of the opening stock, purchases, sales and closing stock and the extent of shortage/ excess/damage and the reasons thereof.

Clause 35 (b) In the case of a manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products:

- A. Raw materials:**
 - (i) opening stock;
 - (ii) purchases during the previous year;
 - (iii) consumption during the previous year;
 - (iv) sales during the previous year;
 - (v) closing stock;
 - (vi) yield of finished products;
 - (vii) percentage of yield;
 - (viii) shortage / excess, if any.

B. Finished products / By-products:

- (i) opening stock;
- (ii) purchases during the previous year;
- (iii) quantity manufactured during the previous year;
- (iv) sales during the previous year;
- (v) closing stock;
- (vi) shortage / excess, if any.

This information should be given only in respect of those items where it is practicable to do so, having regard to the records maintained by the assessee.

In a large concern it may be difficult for tax auditor to verify each and every item of purchase, consumption and production. In such cases, he may verify the figures on a sampling method and satisfy himself as to the correctness of the figures furnished. This clause requires that quantitative details of "principal items" of raw materials and finished goods should be given. Therefore, information about petty items need not be given. The information about 'yield', 'percentage of yield', and 'shortages/ excess' is also required to be given.

In respect of assesseees other than companies and those whose accounts have not been audited under any other law, the tax auditor should obtain the following certified documents for the principal items of raw materials, finished goods and by-products:

- (a) Certificate from the assessee certifying the balance of the opening stock, purchases, sales and closing stock.
- (b) Certificate to the extent of shortage/excess/damage and the reasons thereof.

Clause 36: In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form:-

- (a) total amount of distributed profits;
- (b) amount of reduction as referred to in section 115-O(1A)(i);
- (c) amount of reduction as referred to in section 115-O(1A)(ii);
- (d) total tax paid thereon;
- (e) dates of payment with amounts.

Section 115-O provides for a special levy at the prescribed rate, on the amount of dividend declared, distributed or paid by such company whether such dividend is out of current profit or accumulated profits. Vide this clause the tax auditor has to report on profit distributed during the financial year and therefore, the amount of tax worked and paid out on such distributed profit at the prescribed rate plus surcharge at the applicable rate on the tax along with the education cess thereon has to be reported against this clause. The amount of the dividend referred to in sub-section (1) is to be reduced by the amount referred to in sub-section (1A). Since the tax is payable on such reduced amount, the gross amount may be reported in the sub-clause (a) and the amount of reduction as referred to in section 115-O(1A)(i) and 115-

O(1A)(ii) shall be reported in sub-clause (b) and (c) separately. The tax auditor should keep the working papers to reveal how the net amount has been arrived at.

The tax auditor should maintain the prescribed information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

Clause 37: Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/ quantity as may be reported/identified by the cost auditor.

Clause 38: Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/ identified by the auditor.

Clause 39: Whether any audit was conducted under section 72A of the Finance Act, 1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/ identified by the auditor.

Explanation for Clauses 37, 38 & 39: The tax auditor should ascertain from the management whether Cost Audit/ Excise Audit under the Central Excise Act, 1944/Service Tax Special Audit as per section 72A of the Finance Act, 1994 and if such audit was carried out, obtain a copy of the report. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported / identified by the auditor. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

In cases where cost audit /excise audit/service tax audit which might have been ordered is not completed by the time the tax auditor issues his report, he has to report appropriately in this report stating that since cost audit is not completed and the cost audit report is not available with the assessee.

The tax auditor should examine the time period for which the cost audit /excise audit/service tax audit if any has been required to be carried out. Information is required to be given only in respect of such cost audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that cost audit report which is received up to the date of tax audit report.

Clause 40: Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:

Serial number	Particulars	Previous year	Preceding previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		
4.	Stock-in-trade/turnover		
5.	Material consumed/finished goods produced		

15.59 Advanced Auditing and Professional Ethics

(The details required to be furnished for principal items of goods traded or manufactured or services rendered)

These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in (5) need not be given for trading concern or service provider.

Clause 41: Please furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 along with details of relevant proceedings.

The auditee may be assessed under various tax laws other than Income-tax Act, 1961 and Wealth-tax Act, 1956 resulting into a demand order or a refund order. The tax auditor should obtain a copy of all the demand/ refund orders issued by the governmental authorities during the previous year under any tax laws other than Income Tax Act and Wealth Tax Act. The auditor should exercise his professional judgment in determining the applicability to relevant tax laws for reporting under this clause.

It may be noted that even though the demand/refund order is issued during the previous year, it may pertain to a period other than the relevant previous year. In such cases also, reporting has to be done under this clause. .

If there is any adjustment of refund against any demand, the auditor shall also report the same under this clause.

The tax auditor should maintain the information prescribed in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

SIGNATURE AND STAMP / SEAL OF THE SIGNATORY: Form 3CD has to be signed by the person competent to sign Form No. 3CA or Form No.3CB as the case may be. He has also to give his full name, address, membership number, firm registration number, wherever applicable, place and date. Further, the e-filing portal requires the tax auditor to affix his Digital Signature while registering himself. He is also required to put his stamp/Seal as well.

CODE OF ETHICS AND OTHER MATTERS: Some of the issues which are commonly raised in regard to different aspects of tax audit vis-à-vis the liability / obligations of the tax auditor are considered hereunder.

1. The liability of the tax auditor in respect of tax audit will be the same as in any other audit assignment. It may be noted that when any question relating to the audit conducted by a tax auditor arises, he is answerable to the Council of the Institute under the Chartered Accountants Act. In all matters concerning tax audit, ICAI's disciplinary jurisdiction will prevail.
2. In case the assessee is found guilty of having concealed the particulars of his income it would not ipso facto mean that the tax auditor is also responsible. If the Assessing Officer comes to the conclusion that the tax auditor was grossly negligent in the performance of his duties, he can refer the matter to the ICAI so that appropriate action can be taken against the tax auditor under the Chartered Accountants Act.

3. The Assessing Officer or any other authority who is authorised to issue summons and to call for evidence or documents, can call upon the tax auditor who has audited the accounts to give any evidence or produce documents. For this purpose notice under section 131 can be issued by the Assessing Officer or other tax authority mentioned in the said section.
4. If the actual work relating to examination of books and records is done by a qualified assistant in a firm of chartered accountants and the partner of the firm signing the audit report has relied upon this work, action, if any, for professional negligence can be initiated against the member who has signed the report and in such an event, it would be open for the member concerned to prove that he has taken due care and diligence in the performance of his duties and is not aware of any reason to believe that he should not have so relied.
5. If the qualified assistant (whether or not holding the certificate of practice) is found to be grossly negligent in the performance of his duties, the Council of the Institute can take disciplinary action against him.
6. A tax auditor can accept the assignment of tax representation.
7. Under the Code of Ethics, no tax auditor can charge professional fees by way of percentage of profits or which are contingent upon findings, or results of such employment, except as permitted under any regulation made under this Act
8. Since the figures in Form No. 3CD are duly verified by a chartered accountant, they should normally be accepted by tax authorities. If, however, there is a specific reason for differing from the view taken by tax auditor, the Assessing Officer may compute the income of the assessee by adopting different figures.
9. The opinion expressed by the tax auditor is not binding on the assessee. If the tax auditor has qualified his report and expressed an opinion on a particular item, the assessee may take a different view while preparing his return of income. In such cases, it is advisable for the assessee to state his viewpoint and support the same by any judicial pronouncements on which he wants to rely.

Format of Financial Statements: The tax auditor of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited has to give his report in Forms No. 3CB/3CD and will have to ensure that the financial statements i.e. balance sheet and profit and loss account/ income and expenditure statement, are prepared in such a manner that adequate information which is necessary to convey a true and fair view of the state of affairs of the assessee is given. So far as a person whose accounts of the business or profession have been audited under any other law is concerned, the information to be given in the financial statements is normally provided in the particular statute by which the assessee is governed. Since there is no such legislation in respect of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, it is necessary to achieve some uniformity in respect of information to be provided in the financial statements. For presentation and disclosure requirements, applicable AS and AS (IT) should be kept in mind.

[Students may refer “Guidance Note on Tax Audit under Section 44AB of the Income Tax Act, 1961”- 2014 edition given in CD with Handbook on Auditing Pronouncements for comprehensive knowledge.]

15.4 Audit Provisions under VAT Law

Some of the major States who have introduced VAT on 1.4.2005 and some other States which are in waiting to implement VAT have incorporated audit provisions in their VAT Legislations. Some of the important features of these provisions along with the eligibility of the professionals to undertake the audit function and their supportive role for the successful implementation of the VAT system are dealt with in following paragraphs.

15.4.1 Necessity of audit: Like majority of the developing economies our country is also facing the problem of lack of education and awareness about tax laws, more particularly amongst the trading community. Further, the VAT System of taxation is new to them. Since the trading community is not educated enough and equipped to understand the implications of the VAT system of taxation immediately, there is every possibility that they may not be in a position to arrange their business affairs to fall in line with the requirements of the State Level VAT, calculate and discharge their exact tax liability under the VAT Law. On the other hand, the tax administrator i.e. the authorities in the taxation department also find themselves devoid of sufficient resources to educate the tax payers and inform them about the procedural and accounting changes that are necessitated by the implementation of VAT system.

Another reason for prescribing an audit under the VAT law by a Chartered Accountant, is that under the VAT system a major thrust is to be laid on the ‘self assessment’ meaning thereby that the tax liability calculated and paid by the tax payers through their periodical returns will be accepted by and large and the tax payers will not be called to substantiate the tax liability shown by them in the returns by producing books of account and other relevant material. The assessments with books of account will be an exception. Therefore, there is a strong need to see that the tax payers discharge their tax liability properly while filing the returns. This can be ensured only where the particulars furnished by the tax payers are verified by an independent auditor in minute details by going not only through the books of account but also by analysing and interpreting the provisions of the State-Level VAT Laws and reporting, whether any under-assessment was made by the dealer requiring additional payment or whether there was any excess payment of tax warranting refund to the tax payer. In most of the countries tax evasion is rampant under the existing tax systems. In India too evasion of excise and sales-tax is estimated to be very high. If no audit is prescribed under VAT law, the chances of evasion of VAT tax will increase causing revenue leakage for the Government. It is, therefore, essential that the audit of the proposed VAT system is attempted on a regular basis. However, it is not possible to conduct the audit of all the VAT dealers. Therefore, the criteria for audit can be the amount of turnover or the class of dealer dealing in specified commodities.

The concept of audit is popular even in foreign countries where the system of VAT is in practice since long in the field of indirect taxation. In countries like France and Korea the audit has proved to be an effective tool to check the evasion of tax, which was mostly done by producing fake invoices etc.

Since VAT is a new concept, some of the States want to keep the procedural formalities to the minimum. Hence at the initial stage their law makers refrain from keeping any audit provisions in their Act and rules. Perhaps, this may be due to the initial stage of introduction of VAT. But most of the States, keeping in mind the importance of audit, have incorporated the audit provisions since inception.

15.4.2 The role of the tax auditor: The role of tax auditor in the initial years of implementation of VAT would be that of an adviser to the taxpayers. This role will cast upon him the responsibility to educate and guide the auditee regarding the maintenance of proper records and in assisting the auditees in maintaining accounting records in such a manner as to get the information needed for filing of return without delay and extra efforts. In playing the advisory role the auditor will have to help in devising a proper accounting system as will generate the required information regarding the output tax, input tax credit etc. While doing so the auditor may take the guidance from the guidance notes issued by the Institute of Chartered Accountants of India, New Delhi.

The role of tax auditor vis-a-vis the tax administrators is that the auditor while discharging his function finds out whether the turnover of sales/purchases is shown correctly in the returns and is backed up by the accounts and other relevant documents; the deductions claimed by the tax payer from the turnover of sales are genuine and are supported by valid documents; the claim of input tax credit has been properly made i.e. it has not been claimed on the higher side or on such purchases, which are not eligible for grant of input tax credit. There may be certain instances wherein at the time of purchases the goods might have been eligible for set-off and accordingly the same was claimed in the returns but subsequent events might have rendered the input tax credit inadmissible. In such circumstances, it should be the responsibility of the VAT auditor to state whether the inadmissible input tax credit has been reversed or not and if not, he has to point it out in his report. Thus to a certain degree the VAT auditor is expected to assist the VAT administrators in the proper quantification of tax liability of the tax payer and see that State exchequer gets its revenue which is legally due.

15.4.3 Preparation for tax audit under VAT: A tax auditor has to make certain preliminary preparations before the actual execution of tax audit under the VAT law. The major steps required to be undertaken for the preparation are as under:

(i) **Knowledge of business** - After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315- **"Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"** issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further they should make effective use of the knowledge about the business and should consider how

15.63 Advanced Auditing and Professional Ethics

it affects the tax liability reported in the return. The facts and figures in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly, the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

(ii) Obtaining a list of all the accounting records maintained by the auditee - The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation.

(iii) Ascertaining the major accounting policies adopted by the auditee - The auditor should know the major accounting policies based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.

(iv) Evaluation of internal control etc. - Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated, focused and processed. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.

(v) Knowledge about the VAT law and allied laws - The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

15.4.4 Approach to tax audit under VAT: The audit approach of the tax auditor under the value added tax system will be more or less similar to the approach, which is adopted by the

auditor while conducting the tax audit under the provisions of section 44AB of the Income-tax Act, 1961. However, the reporting requirements vary to a considerable extent.

While the auditor has to apply the basic principles of audit he has to keep in mind that the requirements of VAT audit are different and accordingly he should design his audit programme.

While designing the audit program the auditor has to ensure that the program includes the performance of such audit checks as would generate the information which would enable him to ensure the following and also to draw his audit reports.

(i) The turnover of sales /purchases of goods has been properly determined keeping in view not only the generally accepted accounting policies but the definition of turnover of sales in the relevant VAT law. The sales turnover arrived at by applying the generally accepted accounting policies may not be the same as required under the VAT law. To take an example, the sale proceeds of a fixed asset will not form a part of turnover or sales as per the generally accepted accounting policies but will form a part of turnover or sales for the purpose of VAT law. Similarly, the price of goods returned is deducted from the turnover or sales even if the returns are from the sales effected in the previous years, while under VAT law, the goods returned are to be deducted only if they are made within the prescribed time, say six months from the date of sale. Thus, the results of the audit procedure adopted by the auditor should be such as will give him a reasonable assurance regarding the figures of sales reported in the returns. Not only that, he should also be able to get the exact quantum of the sales under reported or over reported duly classified for different tax rates and its impact on overall tax liability. The sales as per the financial statements may include the turnover or sales effected by all the branches, but for the purposes of VAT law the turnover or sales of only those branches will be included which are included in one registration certificate.

(ii) The turnover of purchases should be tested by applying audit checks as will enable the auditor to get the purchases eligible for grant of input tax credit segregated from other purchases. Further, the purchases on which the input tax credit is available in full and the purchases on which it is available partially should also be ascertained correctly. Thereafter, the auditor should get the exact amount of input tax credit available, compare the same with the credit claimed in the returns and report on the excess/short claim of the credit in the returns filed.

(iii) The auditor is also required to comment on the timely filing of the returns under the VAT law. For this purpose the auditor is expected to list out the due dates of filing of returns and find out the reasons for delay in filing the returns if any.

(iv) The auditor is also required to give his report on the composition scheme. He should apply such compliance tests as will be enable him to ascertain that the auditee is eligible for composition, it has paid the requisite composition fee and all the procedural formalities in relation thereto have been complied with.

(v) The auditor has to give his report on the TDS. Therefore, such tests are to be applied as will enable him to report on the applicability of TDS provisions, the accuracy of the amount deducted and paid, timely issue of TDS certificate and filing of TDS returns.

(vi) The auditor is also expected to check the consolidation of the returns filed for all the periods covered in the year under audit, both under the State-Level VAT law and the Central Sales-tax Act,

15.65 Advanced Auditing and Professional Ethics

1956. These returns are to be compared with the books of account and the documentary evidences available. The auditor is expected to apply such substantive steps as would enable him to judge whether all the transactions relating to sale and purchase are entered in the books of account and have been taken into consideration while filing the returns. In case of any inconsistency a proper reconciliation of book figures and the returned figures should be made and also the correct quantification of tax liability is to be done.

The above are only the major areas which are to be tested by the auditor while conducting the tax audit under VAT laws. The auditor has to take a judgement of his own regarding the adequacy and appropriateness of the audit checks to be applied and the areas where the tests are to be applied, so as to give him all the information needed to form a view not only on the authenticity of the books of account, correctness of the returns filed but also in the quantification of tax liability.

15.4.5 Audit report under the VAT law: All State-Level VAT laws have been framed by following a common VAT law Module suggested by the Central Government. Further the Empowered Committee which pioneered the concept of model VAT law based on certain common principles also insisted that the basic framework of all the VAT laws in the various States should be common. It is felt that there should be a common design for VAT Audit Report also so that the auditor should not find it difficult to conduct the audit and the reports can be made more meaningful and comprehensible to all. The Institute of Chartered Accountants of India has already taken a major initiative in this direction and has already developed a standard format of the audit report. The standard format of audit report was also submitted to the Empowered Committee. States can take the benefit of the same and incorporate the format of the audit report suggested by the ICAI in their VAT laws.

At the end of the audit the auditor has to arrive at his conclusion on the matters to be reported in the audit report. The format of the audit report is generally prescribed under the relevant VAT law and the auditor has to fill in all the columns of the audit report that are applicable. While performing the audit under VAT law the auditor is expected to conduct the audit presuming himself to be the tax assessor. His audit report will therefore have to be comprehensive commenting on each and every aspect which goes to the root of quantification of tax liability. The auditor is expected to give his opinion on the adequacy of accounting records, correctness and completeness and arithmetical consistency of returns filed. Further he has to State the basis of his opinion on the accounts, financial statements and the documents verified by him to arrive at the above conclusion. The auditor is also expected to give the summary of additional tax liability/additional refund arising on his verification of the returns together with the books of account. While the auditor is giving a general opinion on the truth and fairness of books and account he can make a qualified opinion or an unqualified opinion. He can also report to disclaimer where he finds that the accounting records were insufficient to enable him to frame either a unqualified opinion or a qualified opinion.

So far as the comment on the variation of tax liability is concerned the auditor has to quantify exactly the amount by which the liability increases or decreases. He has also to State the transactions against which there is variation in tax liability. Therefore, either he has to State that the tax liability shown in the return is correct or is incorrect and to what extent. Thus, an amount of certification of tax liability is involved therein which casts greater responsibility on the auditor.

Several State VAT Legislations have provided for audit of accounts by chartered accountants. Such audit becomes necessary whenever the turnover of the assessee exceeds the prescribed limit under the relevant State VAT Legislations. In this context the ICAI has developed a model State VAT Audit report. Maharashtra VAT legislation has also prescribed a form of audit report and also the details to be furnished along with the audit report. The audit report and the prescribed details are largely similar to the Model VAT Audit report developed by the ICAI. The objective of furnishing such details is to help the VAT authorities to determine the correct turnover and also to satisfy themselves whether the VAT has been remitted properly to the credit of the State Government. Wherever applicable such particulars have to be verified by the Chartered accountants. Such verification ensures that the input VAT credit has been claimed by the assessee in a proper manner.

Student may note that Government of India is geared up to roll out the GST regime - unified tax regime - by subsuming the major indirect taxes namely, central excise, service tax, VAT/sales tax, CST, luxury tax, etc. presently being levied on goods and services by the Centre and States. GST would be applicable on the supply of goods or services as against the present concept of tax on the manufacture and sale of goods or provision of services. It would be a destination based consumption tax.

16.1 Concept of Cost Audit



According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan.

Cost audit, therefore, comprises:

Fig.: Cost Audit*

- (a) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques, and
- (b) examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

It, therefore, means that the cost auditors attention and approach should be to see that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. The cost auditor should examine whether the methods laid down for ascertaining expenses as direct or indirect are cases in point. The cost auditor should also establish the correctness or otherwise of the figures by the processes of vouching verification, reconciliation etc.

The origin of the concept of cost audit could be traced to the Second World War period when the practice of assigning cost plus contracts started. However, probably India is the only country in the “free” world where cost audit is statutorily prescribed. Cost audit can offer valuable assistance to the management in its decision making process since it ensures reliable cost accounting data and information. The management will be in a position to know what price is to be fixed for a product, whether the wastages are avoidable, whether to re-organise purchase or sales or inventory systems to make the work more efficient and so on. Existence of such a system of audit will also be of great use for maintaining internal control and internal check and can be an advantageous even to the statutory financial auditor. Cost audit, apart from having all the normal ingredients of audit namely vouching, verification etc. has within its compass elements of efficiency audit.

* Source of image: www.costaudit.org

16.2 Types of Cost Audit

Cost audit is basically carried out at the instance of the management for obvious advantages. Apart from this, different other circumstances also sometimes occasion audit of cost accounts. The different types of cost audit that we come across may be the following:

16.2.1 Cost audit on behalf of the management

The principal object of this audit is to see that the cost data placed before the management are verified and reliable and they are prepared in such detail as will serve the purpose of the management in taking appropriate decisions. The detailed objectives include-

- (a) Establishing the accuracy of the costing data, as for example, cost of material used, allocation of wages into direct and indirect and on different products, functions and cost centres.
- (b) Ensuring that the objectives of cost accounting are being achieved through appropriate collection, segregation, analysis and compilation of data.
- (c) Ascertaining abnormal losses and gains along with the relevant causes, expressed in financial terms in a manner that the person responsible for such loss or gain is identified.
- (d) Determination of the unit cost of production in a precise but practicable manner.
- (e) Establishing proper overhead rates for absorption of overheads by various units of costs so that the cost is properly ascertained and there is no significant over or under recovery of expenses.
- (f) Fixation of contract price and the determination of the additional or supplementary charge that can be raised against customers for alterations, etc.
- (g) Improving the quality of cost accounting system by obtaining the audit observations and suggestions of cost auditor.

16.2.2 Cost audit on behalf of a customer

In case of cost plus contracts, often the buyer or the contractee insists on a cost audit to satisfy himself about the correct ascertainment of cost. More often than not, the provision, for a cost audit in such a circumstance is put in the relevant contract with the stipulation that the supplier or the contractor will extend all co-operation to the cost auditor. The cost of production arrived at for this purpose may differ from the cost of production ascertained for internal purposes.

16.2.3 Cost audit on behalf of Government

Sometimes, government is approached with requests for subsidies, protection, etc. Before taking a decision the government may prefer to have the cost of production of the product determined on the basis of cost audit to satisfy itself whether the need is genuine or the industry seeking assistance is generally efficiently run. The government, of its own also may initiate cost audit, in public interest to establish the fair price of any product.

16.3 Advanced Auditing and Professional Ethics

16.2.4 Cost audit by trade association

Where activities of a trade association include maintenance of a price of the products manufactured by the member units or where there is pooling or contribution arrangements, the trade association may require the accuracy of costing information submitted by the member-units checked. The trade association may seek full information on the costing system, level of efficiency, utilisation of capacity, etc.

16.2.5 Statutory cost audit

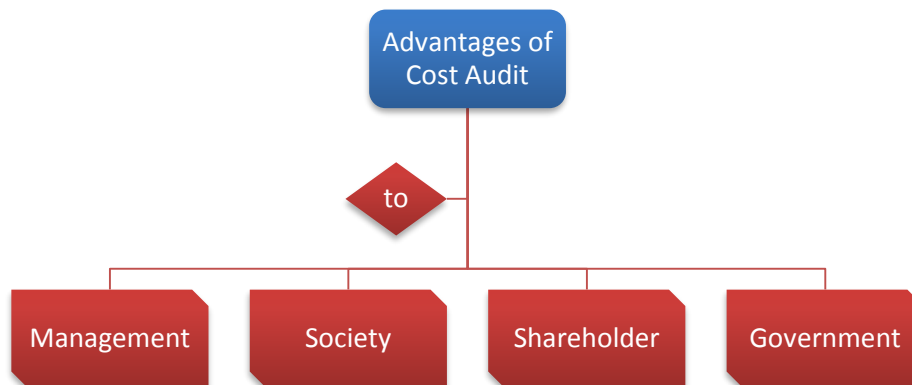
This is covered by the provisions of section 148 of the Companies Act, 2013.

Apart from the aforesaid types of cost audit, the undernoted circumstances may warrant the introduction of cost audit:

- (a) **Price fixation** - The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc. may be useful in knowing the true cost of production.
- (b) **Cost variation within the industry** - Where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.
- (c) **Inefficient management** - Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.
- (d) **Tax-assessment** - Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.
- (e) **Trade disputes** - Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.

16.3 Advantages of Cost Audit

Cost audit will prove to be useful to the management, society, shareholders and the government.



The advantages are as under:

16.3.1 To Management

- (i) Management will get reliable data for its day-to-day operations like price fixing, control, decision-making, etc.
- (ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management.
- (iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.
- (iv) Management by exception becomes possible through allocation of responsibilities to individual managers.
- (v) The system of budgetary control and standard costing will be greatly facilitated.
- (vi) A reliable check on the valuation of closing stock and work-in-progress can be established.
- (vii) It helps in the detection of errors and fraud.

16.3.2 To Society

- (i) Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so the consumers are saved from exploitation.
- (ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

16.3.3 To Shareholder

Cost audit ensures that proper records are kept as to purchases and utilisation of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing stocks and work-in-progress is on a fair basis. Thus the shareholders are assured of a fair return on their investment.

16.3.4 To Government

- (i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.
- (ii) Cost audit helps in the fixation of ceiling prices of essential commodities and thus undue profiteering is checked.
- (iii) Cost audit enables the government to focus its attention on inefficient units.
- (iv) Cost audit enables the government to decide in favour of giving protection to certain industries.
- (v) Cost audit facilitates settlement of trade disputes brought to the government.
- (vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

16.4 Functions of Cost Auditor

The Institute of Cost and Works Accountants of India has detailed the principal functions of a cost auditor by way of comparison with the functions of the auditor of financial accounts. The principal functions of cost auditor, according to the aforesaid Institute are the following:

(i) Inventory

- (a) Is the size of the inventory adequate or excess compared with the production programme?
- (b) Is the provision most economical?
- (c) Does it ensure optimum order size?
- (d) Does it take into account the storage cost on the one hand, and carrying cost on the other?
- (e) Does it take note of lead time of the various items or groups of items?
- (f) Does the receipt and issue system cause any bottle-neck in production?
- (g) Does it involve too many forms and too much paper work?
- (h) Is there any room for reduction of inventory cost consistent with production needs?
- (i) Is the inventory as per the priced store ledger and as certified by the management physically correct?
- (j) Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?
- (k) Does the issue of raw materials make the production in accordance with the standard or schedule or otherwise or covered by authorised schedule?
- (l) Is the expenditure of consumable stores within the standard? If not, why not?

(ii) Opening and Closing Stocks - The cost auditor will see the following:

- (a) that the opening stock is not unduly large compared with the volume of production during the year;
- (b) that the opening stock against various jobs really represents the actual physical stock in the production shop and is not merely an accounting figure;
- (c) that the responsibility of the shop foreman in-charge of the stock held in the production shop is clear and properly documented; that he maintains proper record of actual consumption vis-a-vis the actual withdrawal from the stock.

Valuation and correct indication of closing stock in the Trading and Profit and Loss Account and in Balance Sheet is equally important. The Cost Auditor will examine and certify:

- (a) that the physical verification is correctly carried out;
- (b) that the valuation is correct with reference to the actual cost of production and recognised policy for valuation;

- (c) that volume of closing stock is commensurate with the volume of production and that it does not reflect any failure or bottleneck in sales budget or production budget;
- (d) that the volume of unmoved stores is not abnormal in comparison with the normal rate of yearly consumption. The Cost Auditor will recommend disposal of such unmoved stores with consequent release of capital unnecessarily locked up to the advantage of the financial resources of the concern.

(iii) Store Issue Procedure in Stocks - The Cost Auditor will see:

- (a) that withdrawal of materials or stores to production shop is scientific or covered by authorised schedule and permits receipt to be located;
- (b) that there is no possibility of loss or pilferage of stock lying in the production section;
- (c) that surplus materials and scraps arising in production shops are returned to stores correctly and without delay for which necessary credit is given to unit cost of production. If transferred to other jobs, proper transfer voucher has been prepared and copies sent to the accounts, stores, etc.

(iv) Work-in Progress - The Cost Auditor will see the following:

- (a) that work-in-progress has been physically verified and that it agrees with the balance in the incomplete cost card;
- (b) that valuation of the work-in-progress is correct with reference to stage of completion of each job or process and the value job cost cards or process cost sheet;
- (c) that there is no over-valuation or under-valuation of opening work-in-progress or closing work-in-progress, thereby artificially pushing up and down net profits or net assets as the case may be;
- (d) that the volume and value of work-in-progress is not disproportionate compared with the finished out-turn.

(v) Labour -

- (a) Proper utilisation of labour and increase in productivity are now receiving attention, several productivity teams have emphasised importance of higher productivity. It is, therefore, essential to assess the performance efficiency of labour and compare it with standard performance, so that labour utilisation could be progressively improved. The labour force in Indian industries is generally very high compared to similar types of industries in other developed countries. Our aim should be to reach that level, though not immediately but over some time. A study of this nature would give an idea where the inefficiency lies so that timely and adequate steps could be taken to ensure maximum utilisation of labour to reduce labour cost.
- (b) Cost of labour is allocated to different jobs with reference to time or job cards.

16.7 Advanced Auditing and Professional Ethics

(vi) **Capacity Utilisation** -The cost auditor will see:

- (a) that the idle capacity in any production shop or of transport facilities for distribution is not excessive;
- (b) that production volume and overall machine time utilised are commensurate. In other words, the machine hours utilised have given the optimum output.

(vii) **Overheads and indirect expenditure** - The cost auditor will see and certify:

- (a) that allocation of indirect expenditure over production, sales, and distribution is logical and correct;
- (b) that compared with the value of production in a production shop, overhead charges are not excessive;
- (c) that actual indirect expenditure does not exceed budgets or standard expenditure significantly and that any variations are satisfactorily explained and accounted for;
- (d) that the relation of indirect expenditure in keeping with the load on individual production shop is appropriate;
- (e) correctness of appropriate allocation of overhead expenditure (both production and sales) will be certified by the cost auditor;
- (f) that allocation of overheads between finished products and unfinished products is in accordance with correct principles.

Shortly we shall discuss in detail the aspects to be dealt with in the cost auditor's report pursuant to the Companies (Cost Records and Audit) Rules, 2014. The aforesaid Rules have been issued pursuant to section 148 of the Companies Act, 2013 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

It may be noted that the requirement of the statutory cost audit in our Companies Act is something special, because statutes in most of the other countries do not contain a similar requirement. In most of the countries the concept of cost audit as such is also non-existent and the objectives, whatever they may be, are achieved by properly designing the scope and depth of internal audit.

The object with which the statutory requirement of cost audit has been included in the Companies Act can only be ascertained by a study of the cost audit report requirements. They include control over cost, wastage and losses, efficiency in the utilisation of human, material, and other resources, determination of appropriate selling price, proper maintenance of cost records appropriate use of the costing system, etc.

16.5 Programme of Cost Audit

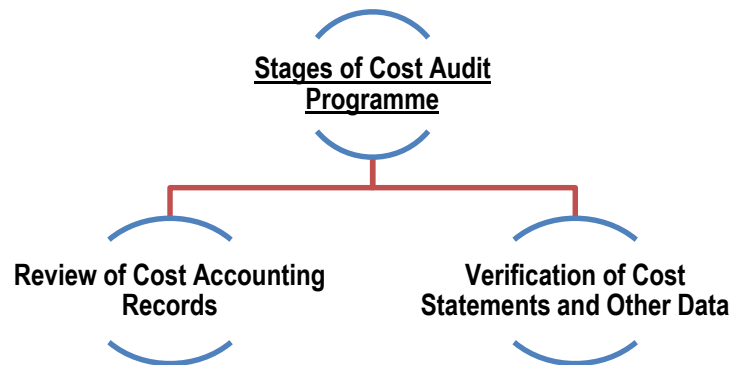
The audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. However, the significant things that should not be missed are: proper vouching of expenses, capital and revenue character determination, allocation of expenses,

apportionment of overheads, arithmetical accuracy, the statutory requirements, examination of contracts and agreements, review of the Board's and shareholders' minute books to trace important decisions having bearing on costs, verification of title deeds and documents relating to properties and assets, etc. Cost audit, in order to be effective, should be completed at one time as far as practicable. The exact content of cost audit largely depends on the size of the organisation, range of products, production process, the existence of a well organised costing department and of a well designed costing system, and the existence of a capable internal auditing system. Other relevant considerations may be:

- (a) System of cost accounting in vogue and the organisation of the cost department, forms, schedules, etc.
- (b) System of internal check used in the organisation.
- (c) Frequency of audits, areas to be covered, volume of transactions, efficiency of the internal check, needs of management, purpose of cost audit, its benefits, etc.

After considering the aforesaid factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Like every other audit, a systematic planning of cost audit routine is necessary.

Broadly speaking cost audit programme may be divided into the following stages:



- (a) **Review of Cost Accounting Records** - This will include:
 - (i) Method of costing in use - batch, process or unit.
 - (ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.
 - (iii) System of recording wages, salaries, overtime and spares, wastages, etc.
 - (iv) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.
 - (v) Treatment of interest, recording of royalties, research and development expenses, etc.
 - (vi) Method of accounting of depreciation.

16.9 Advanced Auditing and Professional Ethics

- (vii) Method of stock-taking and its valuation including inventory policies.
- (viii) System of budgetary control.
- (ix) System of internal auditing.

(b) Verification of cost statements and other data - This will include the verification of:

- (i) Licensed, installed and utilised capacities.
- (ii) Financial ratios.
- (iii) Production data.
- (iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.
- (v) Sales realisation.
- (vi) Abnormal non-recurring and special costs.
- (vii) Cost statements.
- (viii) Reconciliation with financial books.

16.6 Cost Audit under the Companies Act

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

Cost Audit is covered by section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

As per the section 148, the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

However, the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

The Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account.

These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006. The said rule has divided the list of companies into regulated sectors (Part A) and non-regulated sectors (Part B).

As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year commencing, is required to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, the auditor is also required to report as per clause (vi) to Paragraph 3 of the CARO, 2016, which is discussed below:

“Whether maintenance of cost records has been specified by the Central Government under sub-section (1) of Section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.”

Audit Procedures and Reporting:

The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word “made” applies in respect of cost accounts (or cost statements) and the word “maintained” applies in respect of cost records relating to materials, labour, overheads, etc. The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the central government.

The auditor should obtain a written representation from the management stating:

- (a) whether cost records are required to be maintained for any product(s) or services of the company under section 148 of the Act, and the Companies (Cost Records and Audit) Rules, 2014; and***
- (b) whether cost accounts and records are being made and maintained regularly.***

The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore, conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.

It is necessary that the extent of the examination made by the auditor is clearly brought out in his report. The following wording is, therefore, suggested:

“We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 148 of the Act, and are of the opinion that prima facie, the prescribed accounts and records have been made and maintained.”

Where the auditor finds that the records have not been written or are not prima facie complete, it will be necessary for the auditor to make a suitable comment in his report.

Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an auditor within one hundred and eighty days of the commencement of every financial year. ***However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.***

The certificate to be obtained from the cost auditor shall certify that the-

- (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;***
- (b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;***
- (c) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and***
- (d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.***

Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in Form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

The cost auditor appointed as such shall continue in such capacity till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

However, the cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing.

It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect.

It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.

Casual Vacancy in the Office of a Cost Auditor: Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors

within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

The cost auditor shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his **duly signed** report to the Board of Directors of the company within a period of one hundred and eighty days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

It may be noted that the Board of Directors shall approve the cost statements, including other statements to be annexed to the cost audit report, for submission to the cost auditor to report thereon, before they are signed on behalf of the Board by any of the director authorised by the Board.

Duty to report on fraud: The provisions of sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Cost Audit Rules not to apply in certain cases: The requirement for cost audit under these rules shall not be applicable to a company which is covered under rule 3, and,

- (i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or
- (ii) which is operating from a special economic zone.

(iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

Who can be cost auditor: The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

Appointment and Remuneration of Cost Auditor: As per rule 14 of the Companies (Audit and Auditors) Rules, 2014

- (a) in the case of companies which are required to constitute an audit committee-
 - (i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm

16.13 Advanced Auditing and Professional Ethics

of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;

- (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- (b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Qualification, disqualification, rights, duties and obligations of Cost Auditor: The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It may be noted that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

Submission of Cost Audit Report: A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 *in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015* along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

Penal Provisions in case of default: If any default is made in complying with the provisions of this section,

- (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147 (Section 147 is discussed separately in Chapter 6);
- (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147. (Section 147 is discussed separately in Chapter 6).

16.7 Steps in Cost Audit

Broadly, cost audit is comprised of three steps i.e., review, verification and reporting.



Review - Collection and assimilation of all the relevant information and technicalities about the industry is an essential prerequisite of cost audit. The review should cover the following aspects:

1. Nature of the industry - priority industry, export-oriented industry etc.
2. Production method/process.
3. Important raw materials and their sources.
4. Licenced capacity and installed capacity.
5. Method of costing in use.
6. Method of accounting of raw materials, stores and production.
7. Method of accounting of wastages, spoilages and rejections.
8. Records relating to jigs and dies.
9. System of wages, salaries & overtime payment including incentive schemes, if any.
10. Basis of allocation of overheads to cost centres and of absorption to products.
11. Method of allocation of service department expenses.
12. Treatment of interest on borrowings.
13. Method of accounting of depreciation.
14. Agreement with collaborators or others for payment of royalty, its computation and payment.
15. Treatment of research and development expenses.
16. Accounting for sales and purchase - treatment with regard to sales tax, excise duty, etc.
17. System of year-end stock-taking.
18. Method of determination of work in progress.
19. Inventory valuation policy and method.
20. System of budgetary control.
21. System of internal audit.

16.15 Advanced Auditing and Professional Ethics

22. State of internal control over cost accounts and cost accounting records.
23. Cost accounting manual, if any.
24. Special cost accounting practice and methods peculiar to the industry under audit.

The cost auditor should familiarize himself with the memorandum and articles of association, past audit reports on the financial accounts, annual reports issued by the Board, the Chairman's speech, etc. He should also thoroughly review the costing system in vogue in relation to the production process and method, and should have a detailed knowledge of the flow of the production process and the documents that arise or are received in that course. A list of the costing books of account maintained by client should also be obtained by the cost auditor so that he knows the purpose and contents of such books.

A detailed audit programme should thereafter be prepared so that the work to be done and the manner in which it is to be done are planned. Students already know the purpose, contents and utility of an audit programme in the context of audit of financial accounts. All these are equally applicable in case of cost audit. Also, the cost auditor should do recording of all relevant information about the client, his business, production process, unresolved queries and matters requiring follow-up or discussion in a properly organised audit note book and working papers. Here again the functions and utilities are the same as in the case of financial audit and note books and working papers can be maintained in the very same manner as in the case of financial audit.

It is definitely desirable that the cost auditor should plan his test checking on the basis of strict rules of statistical sampling so that he knows how much risk he takes in adopting test checks and how reliable would be the opinion that he will express. He should also carefully study and evaluate internal controls and their operation on the costing books and records before deciding in favour of test of cost audit and may defer the appointment of the cost auditor as much as it can and thereby reduce further the time available to him.

Verification of cost statements and other data - The examination of the cost statements and other records by the cost auditor will generally cover the following:

- (i) Licensed capacity, installed and utilised capacities;
- (ii) Financial ratios;
- (iii) Production data;
- (iv) Cost of raw materials consumed;
- (v) Cost of power and fuel;
- (vi) Employee costs;
- (vii) Cost of stores etc. consumed;
- (viii) Provision for depreciation;
- (ix) Overheads and their allocation;
- (x) Royalty and technical aid payments;

- (xi) Sales relationships, local & export;
- (xii) Abnormal, non-recurring and special cost;
- (xiii) Cost statements;
- (xiv) Reconciliation with financial books.

Necessity to refer to financial records - It is needless to mention that the cost audit programme should cover all the above and any other matter that the cost auditor considers necessary. It is also obvious that cost audit under the Companies Act cannot be performed without reference to financial books and records. This is simply for the reason that apart from the requirement to have reconciliation between cost and financial accounts done. The cost statements are to contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Companies (Cost Records and Audit) Rules; overhead expenditure also needs allocation between activities covered by the rules and activities not so covered. Naturally, this can be done only by reference to the financial ledger. Expenses like salaries and wages may not be fully reflected in the cost statements and to ascertain whether appropriate charge has been made in the cost records, there would invariably be a necessity to refer to the full charge for salaries and wages in the financial ledger. Under the requirement of Part II of Schedule III to the Companies Act, 2013, quite a few matters are there which could be of direct relevance to the cost auditor - for example, consumption of raw materials, purchases of stock-in-trade, sales of products/services, changes in inventories in respect of finished goods, work-in-progress, stock-in-trade etc.

We can see from the above discussion that there exists quite a sizeable overlapping between the financial accounting records and cost accounting records. Effectiveness of both the audits, and specially cost audit, can be enhanced substantially if appropriate available data, and documents pertaining to the other field are kept in view while making audit verification. It may especially help the audit (cost and financial both) to locate errors, mistakes and omissions present in either set of accounts. If the cost auditor takes the pain of correlating the consumption of raw materials as appearing in the cost records with consumption disclosed in the financial records, he may be able to locate substantial errors either in cost records or in financial records. At least a material discrepancy between the two sets of consumption data will put him on special enquiry about the correctness of costing data and in these process errors in either may be established. Then comes the question: suppose he is convinced of the presence of a mistake in financial accounts after satisfying himself about the correctness of costing records, what he should do? He has no apparent duty to inform the auditor of financial accounts about the detection of the mistake. But nothing forbids him from asking the company to rectify the relevant cost statement where the complete financial data is compiled and allocated between activities covered by the Companies (Cost Records and Audit) Rules and other activities. Also, the reconciliation statement between costing and financial data will invariably contain indication of the discrepancy. Also he may bring the discrepancy to the notice of the management in writing and a copy of such communication may be endorsed to the financial auditor. In fact, no definite course of conduct has emerged as yet but it can be emphasised that the possibility of existence of mistakes in either record being located by the other auditor probably will lead to the

16.17 Advanced Auditing and Professional Ethics

development of necessary rapport between the two auditors. It may be pertinent to note that both the auditors have access to the records in the other field under the authority of law and it is the duty of the each auditor to refer to them to obtain necessary audit evidence that may help him in the discharge of duties cast on him. The auditor of financial accounts examines various allocations of overheads etc. to ascertain whether financial data is at variance with costing data. This he should provide in his audit programme itself. However, it is doubtful whether the cost auditor's report will be made available to the financial auditor even though in great many cases cost audit would be over before financial audit. Further, the provisions related to duty to report on fraud under sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules shall also apply mutatis mutandis to a cost auditor during performance of his functions.

Reporting - After completion of audit of costing and other relevant records the cost auditor is to submit his report. A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein. If, after considering the cost audit report furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

GENERAL FEATURES OF COST AUDIT REPORT -

1. (i) I/We have/have not obtained all the information and explanations, which to the best of my/ our knowledge and belief were necessary for the purpose of this audit.
- (ii) In my/our opinion, proper cost records, as per rule 5 of the Companies (Cost Records and Audit) Rules, 2014, have/have not been maintained by the company in respect of good(s)/service(s) under reference;
- (iii) In my/our opinion, proper returns adequate for the purpose of Cost Audit have/have not been received from the branches not visited by me/us.
- (iv) In my/our opinion and to the best of my/our information, the said books and records give/do not give the information required by the Companies Act, 2013, in the manner so required.
- (v) In my/our opinion, company has/does not have adequate system of internal audit of cost records which to my/our opinion is commensurate to its nature and size of its business.
- (vi) In my/our opinion, information, statements in the annexure to this cost audit report gives/does not give a true and fair view of the cost of production of good(s)/rendering of service(s), cost of sales, margin and other information relating to good(s)/service(s) under reference.
- (vii) Detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product/service under reference of the company duly audited and certified by me/us are/are not kept in the company.

2. If as a result of the examination of the books of account, the cost auditor desires to point out any material deficiency or give a qualified report, he/she shall indicate the same against the relevant para (i) to (vii) in the prescribed form of the Cost Audit Report giving details of discrepancies he/she has come across.
3. The report, suggestions, observations and conclusions given by the cost auditor shall be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

16.8 Rights and Duties of Cost Auditor

The cost auditor enjoys the powers and has the duties as contained in the Companies Act, 2013 which is discussed under Para 6.8 'Powers/Rights of Auditors' and 6.9 'Duties of Auditors' of Chapter 6 'The Company Audit'.

16.9 True and Fair Cost of Production

The true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:

1. Determination of cost following the generally accepted cost accounting principles.
2. Application of the costing system appropriate to the product.
3. Materiality.
4. Consistency in the application of costing system and cost accounting principles.
5. Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.
6. Elimination of material prior-period adjustments.
7. Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

The report of the cost auditor discussed above will be subject to the cost auditor's observations and conclusions, if any. Also the report is subject to observations of the cost auditor on the various matters contained in the Annexure.

Under the Companies (Cost Records and Audit) Rules, 2014, an Annexure has been provided to be filled by the cost auditor and annexed to the report that he makes. The matters contained in the Annexure form part of the cost auditor's report.

[Note: For detailed knowledge of Annexure to the Cost Audit Report, students may refer Form CRA-3 (Pursuant to rule 6(4) of the Companies (Cost Records and Audit) Rules, 2014)].

FINAL COURSE STUDY MATERIAL

PAPER 3

**Advanced Auditing and
Professional Ethics**

MODULE – 3



**BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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CONTENTS

MODULE – 1

- Chapter 1 – Auditing Standards, Statements and Guidance Notes – An Overview
- Chapter 2 – Audit Strategy, Planning and Programming
- Chapter 3 – Risk Assessment and Internal Control
- Chapter 4 – Audit under Computerised Information System (CIS) Environment
- Chapter 5 – Special Audit Techniques
- Chapter 6 – The Company Audit
- Chapter 7 – Liabilities of Auditors
- Chapter 8 – Audit Report
- Chapter 9 – Audit Committee and Corporate Governance
- Chapter 10 – Audit of Consolidated Financial Statements

MODULE – 2

- Chapter 11 – Audit of Banks
- Chapter 12 – Audit of General Insurance Companies
- Chapter 13 – Audit of Co-Operative Societies
- Chapter 14 – Audit of Non Banking Financial Companies
- Chapter 15 – Audit under Fiscal Laws
- Chapter 16 – Cost Audit

MODULE – 3

- Chapter 17 – Special Audit Assignments
- Chapter 18 – Audit of Public Sector Undertakings
- Chapter 19 – Internal Audit, Management and Operational Audit
- Chapter 20 – Investigation and Due Diligence
- Chapter 21 – Peer Review
- Chapter 22 – Professional Ethics

DETAILED CONTENTS: MODULE – 3

CHAPTER 17: SPECIAL AUDIT ASSIGNMENTS

17.1	Audit of Members of Stock Exchanges	17.1
17.2	Functioning of Stock Exchanges.....	17.1
17.3	Rolling Settlement.....	17.9
17.4	Derivatives.....	17.10
17.5	Circuit Filters or Circuit Breakers.....	17.11
17.6	Accounting for Stock Exchange Transactions	17.12
17.7	Conduct of Audit	17.13
17.8	Auditor's Report.....	17.21
17.9	Audit of Mutual Funds	17.22
17.10	Audit of Depositories.....	17.28
17.11	Environmental Auditing	17.30
17.12	Energy Audit.....	17.34
17.13	Audit of Accounts of Non-Corporate Entities (Bank Borrowers)	17.36

CHAPTER 18: AUDIT OF PUBLIC SECTOR UNDERTAKINGS

18.1	Introduction	18.1
18.2	Framework for Government Audit.....	18.2
18.3	Objective and Scope of Public Enterprises Audit	18.5
18.4	Audit of Government Companies	18.7
18.5	Financial Audit.....	18.8
18.6	Compliance Audit.....	18.8
18.7	Performance Audit	18.9
18.8	Comprehensive Audit.....	18.17
18.9	Propriety Audit.....	18.19
18.10	Audit Report of the Comptroller and Auditor General	18.26

CHAPTER 19: INTERNAL AUDIT, MANAGEMENT AND OPERATIONAL AUDIT

19.1	Internal Audit	19.1
19.2	Management functions and scope of Internal Auditing	19.3
19.3	Integrity, Objectivity and Independence of Internal Auditor.....	19.6
19.4	Qualifications of Internal Auditor	19.6
19.5	Internal Audit Report.....	19.6
19.6	Relationship between Internal and External Auditors	19.11
19.7	Management Audit	19.16
19.8	Operational Audit.....	19.31
19.9	Review of Systems and Procedures	19.41
19.10	Management Audit Questionnaire.....	19.44

CHAPTER 20: INVESTIGATION AND DUE DILIGENCE

20.1	Introduction	20.1
20.2	Audit versus Investigation	20.1
20.3	Steps in Investigation.....	20.6
20.4	Special Issues in Investigation	20.9
20.5	Special Aspects in Connection with Business Investigation.....	20.11
20.6	Types of Investigation	20.17
20.7	Due Diligence	20.39

CHAPTER 21: PEER REVIEW

21.1	Introduction	21.1
21.2	Objectives of Peer Review	21.1
21.3	Scope of Peer Review.....	21.2
21.4	Applicability	21.4
21.5	Peer Review Board	21.6
21.6	The Peer Review Process	21.7

CHAPTER 22: PROFESSIONAL ETHICS

22.1	Introduction	22.1
22.2	Fundamental Principles.....	22.2
22.3	Membership of the Institute	22.3
22.4	Chartered Accountants in Practice	22.6
22.5	Chartered Accountants in Service	22.13
22.6	Disciplinary Procedure	22.13
22.7	Types of Misconduct- Professional or Other	22.15
22.8	Schedules to the Act	22.16
22.9	Council Guidelines.....	22.73
22.10	Recommended Self-Regulatory Measures	22.80

Special Audit Assignments

17.1 Audit of Members of Stock Exchanges

A stock exchange is an organized market for the purchase and sale of listed industrial and financial securities. The securities dealt in at a stock exchange include the shares and debentures of public limited companies, Government securities, and bonds and securities issued by the municipal bodies and port trusts, etc. The Securities Contracts (Regulation) Act, 1956 defines a stock exchange as, “an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities.”

The Securities and Exchange Board of India Act was passed by the Parliament and assented to by the President of India in 1992. The powers vested in SEBI under the SEBI Act, 1992 include powers under the Securities Contracts (Regulation) Act like powers to call for periodic and annual returns from stock exchanges, licensing of dealers in securities, amendment to the rules and bye-laws of stock exchanges, etc. The SEBI has wide powers under the Act and the Rules to ensure proper conduct of affairs of the stock exchanges by giving suitable directions, however, the Securities Contracts (Regulation) Act, was promulgated only in 1956. The Securities Contracts (Regulation) Rules were framed thereunder in 1957. The Government has wide powers under the Act and the Rules to ensure proper conduct of affairs of the stock exchanges by giving suitable directions.

17.2 Functioning of Stock Exchanges

It is important for auditor to understand adequate knowledge about important aspects of on functioning of stock exchanges and the manner in which the transactions are entered into by the members of stock exchanges.

17.2.1 Regulation of Stock Exchanges

The Securities and Exchange Board of India (SEBI) is the apex, statutory regulatory body for the securities market with the express mandate of investor protection and development and regulation of market under SEBI Act, 1992. Apart from SEBI, Securities Contracts (Regulation) Act, 1956 which provides for regulation of transactions in securities through control over stock exchanges, Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities, Public Debt Act, 1942, Companies Act, 2013, Banking Regulation Act, 1949 and Income Tax Act, 1961 also have a substantial bearing on the working of the securities market.

17.2 Advanced Auditing and Professional Ethics

17.2.2 Securities and Exchange Board of India

SEBI is a body corporate having perpetual succession. It has been given quite wide powers for the achievement of the objectives of the SEBI Act, 1992. SEBI's main function is to regulate the business in securities market. SEBI, for the purposes of regulation of securities market, can issue directions to stock exchanges, companies, stock brokers or to any other person. SEBI Act, 1992 empowers SEBI to levy monetary fines and penalties on any person incurring a default under the Act in the following cases:

- ◆ failure to furnish any document, information, books, other documents, return or report called for by the Board;
- ◆ failure to maintain books of accounts and records;
- ◆ failure by an intermediary to enter into an agreement with his client, redress the grievances of investors;
- ◆ failure by a person sponsoring or carrying on any collective investment scheme, including mutual funds, without obtaining certificate of registration;
- ◆ failure by a stock broker to issue contract notes in the form and manner specified by the stock exchange, failure to deliver any security or failure to make payment of the amount due to the investor, charging of excess brokerage;
- ◆ any person dealing, communicating, counselling on the basis of some price sensitive information;
- ◆ failure by a person to disclose the aggregate of his shareholding in a body corporate before he acquires any shares of that body corporate and failure to make a public announcement to acquire shares at a minimum price in case of takeovers.

SEBI also has the power to suspend or cancel the certificate of registration of a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee of a trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market. This includes depository, depository participant, custodian of securities, foreign institutional investor and credit rating agency also.

The Securities Contract (Regulation) Act, 1956 empowers any recognised stock exchange may, subject to the previous approval of the Securities and Exchange Board of India, make bye-laws for the regulation and control of contracts.

It may be noted that since SEBI is the regulator of the securities market, the Securities Contract (Regulation) Act, 1956, through section 10, empowers SEBI to make or amend the byelaws of stock exchanges.

17.2.3 Governing Body

The Governing Body of a stock exchange can comprise of elected representatives of the members of stock exchange, nominated public representatives and/or professional directors. The Governing Body has powers, subject to SEBI approval, to make, amend and suspend the

operation of the Rules, Bye-laws and Regulations of the stock exchange besides having jurisdiction over all its members. The Governing Body is specially empowered to admit or expel members and their subordinates.

17.2.4 Membership

Business at a stock exchange, can only be transacted by a member of the stock exchange. A member of NSE cannot transact business at BSE unless he is a member of BSE also. The members of stock exchanges are also called stock or share brokers. The members enter into transactions either on their own behalf or on account of their clients, including sub-brokers. There are several ways of placing an order with a member. It could be either directly or indirectly through a sub-broker. Since the stock exchange operations involve considerable financial commitments on the part of its members, its membership is restricted to persons who are financially sound and possess adequate experience. The Securities Contracts (Regulation) Act, 1956, the SEBI Act, 1992 and various rules, regulations, notifications, etc., lay down the requirements for becoming a member of a stock exchange. Each stock exchange has its own SEBI approved rules and regulations regarding the admission of members. A stock exchange can have membership in multiple trading segments such as Capital Market Segment, Wholesale Debt Market Segment and Derivatives Segment. The deposit / fee structure applicable to a member depends on the trading segments in which the member is admitted.

17.2.5 Classification of Securities Traded

A security (in common parlance also known as scrip) which is allowed to be traded on any Exchange can either be listed with the Exchange or be permitted to be traded without being listed on the Exchange. A listed company is bound by the listing agreement with the exchange. The listed companies have to pay the listing fees as prescribed by the Securities and Exchange Board of India to the Exchange. However, in case of permitted securities, listing fees is not payable to the Exchange.

17.2.6 Margins

There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interests of the investors, members are required to keep certain deposits with the stock exchange authorities. These deposits are termed 'margins'. The members are required to collect the margin from their clients, wherever applicable, and deposit the amount collected with the Clearing House. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays in paying the amount or is unable to meet his commitments. Margins also help prevent excessive speculation as clients would be required to invest some funds and not indulge in speculation without adequate resources. A member is required to pay or deposit different margins such as Gross Exposure Margin, Mark to Market (MTM) Margin, Volatility Margin (VM), Additional Volatility Margin (AVM), Special Margin and Ad-hoc Margin. The members are required to compute margin payable for all securities traded by them and make the margin payments on the due date to the Stock Exchange authorities. Different types of margins are payable at stipulated time, as decided by the Exchange or Clearing House of the Exchange.

17.4 Advanced Auditing and Professional Ethics

Three types of margins, viz., Mark-to-Market Margin, Volatility Margin and Gross Exposure Margins have been explained in the following paragraphs.

(i) **Mark to Market Margin:** MTM margin is the notional loss, which a member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(ii) **Volatility Margin:** Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions. Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits. Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

(iii) **Gross Exposure Margin:** Gross exposure margin is computed on the aggregate of the net cumulative outstanding positions (purchases or sales) in each security. Each Exchange determines its own rates of Gross Exposure Margin and Additional Volatility Margin based on its own risk perception of the market and other risk containment measures such as deposits and collaterals in its possession.

A Stock Exchange may also collect the following margins -

- (i) Special Margin in securities where price manipulation is suspected.
- (ii) Adhoc Margin where it is felt that the margin cover vis-à-vis the exposure of the member is inadequate or a member has a concentrated position in some securities or has common clients along with other members.

17.2.7 Trading System

As stated earlier, a member can transact business at a stock exchange either on his own behalf or on behalf of his clients / sub-broker. Thus, a non-member can purchase or sell shares and other securities only through member or through their authorised and registered sub-broker. The relationship between the client and the member is of a fiduciary nature. When, therefore, the member receives securities from his client for sale, he is obliged to sell the securities as per instructions and to remit the sale proceeds thereof, after deducting brokerage and other related expenses, to his client. Similarly, when on member buys securities for his client, he has to ensure that the shares/securities so purchased are delivered to the client after he has received from the client the payment for the same which includes the

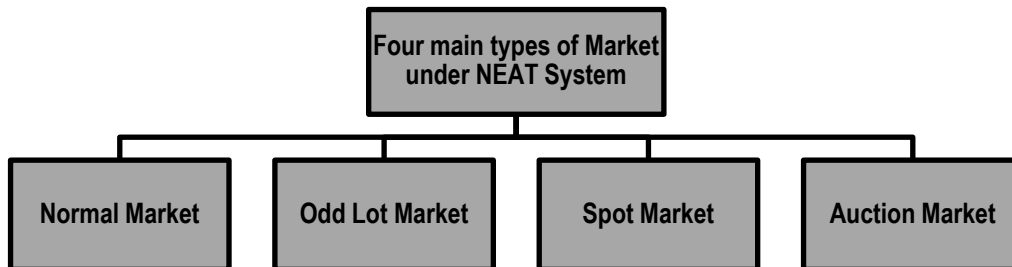
brokerage and other incidental expenses in connection therewith. Thus, a member acts as a custodian and handles the securities of his clients on their behalf. Therefore, the member must ensure that he has received payment from other stock brokers for the securities sold on behalf of his clients. The procedures followed by various Stock Exchanges in the purchase and sale of securities vary. In order to provide a basic understanding of trading on Stock Exchanges, trading systems at National Stock Exchange and the Stock Exchange, Mumbai have been discussed in this Chapter.

17.2.8 Trading on the National Stock Exchange

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully computerised screen-based trading system. It enables members from across the country to trade simultaneously with enormous ease and efficiency by keying the order into the system. A single consolidated order book for each stock displays, on a real time basis, buy and sell orders originating from all over the country. The orders are executed only if the price-quantity conditions match.

17.2.9 Types of Market

The NEAT system has four main types of market. They are-



Normal Market: All orders which are of regular lot size or multiples thereof are traded in the normal market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as regular lot orders, special term orders, negotiated trade orders and stop loss orders, depending on their order attributes.

Odd Lot Market: An order is called an odd lot order if the order size is less than regular lot size; such orders are traded in the odd-lot market. These orders do not have any special terms or attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

Spot Market: Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms or attributes attached to them.

Auction Market: In the auction market, auctions are initiated by the Exchange on behalf of trading members for completing the settlement process.

17.6 Advanced Auditing and Professional Ethics

17.2.10 Order Books

The NSE trading system provides flexibility to members in the kind of orders that can be placed by them. Orders are first numbered and time-stamped on receipt and then immediately processed for potential match. Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different 'books' in price-time priority in the following sequence:

- ◆ Best Price
- ◆ Within Price, by time priority.

Price priority means that if two orders are entered into the system, the order having the best price gets the higher priority. Time priority means if two orders having the same price are entered, the order that is entered first gets the higher priority.

The capital market segment has following types of books:

Regular Lot Book - The Regular Lot Book contains all regular lot orders that have none of the following attributes or conditions* attached to them.

- ◆ All or None (AON)
- ◆ Minimum Fill (MF)
- ◆ Stop Loss (SL)

Special Terms Book - The special terms book contains all orders that have either of the following attributes or conditions attached:

- ◆ All or None (AON)
- ◆ Minimum Fill (MF)

Stop-Loss Book - Stop loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the regular lot book. The stop loss condition is met under the following circumstances:

- ◆ Sell Order - A sell order in the 'stop loss book' gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order.
- ◆ Buy Order - A buy order in the 'stop loss book' gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.

Odd Lot Book - The odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot order against passive orders in the book. Currently, pursuant to a SEBI directive, the Odd Lot Market is being used for orders that have quantity less than or equal to 500 (Quantity more than the market lot) for trading. This is referred as the Limited Physical Market (LPM).

* Conditions are explained later in the Chapter.

Spot Book - The Spot Lot Book contains all spot orders (orders having only the settlement period different) in the system. The system attempts to match an active spot lot order against the passive orders in the book.

Auction Book - This book contains orders that are entered for all auctions.

17.2.11 Trading on The Stock Exchange, Mumbai (BSE)

The Exchange, which hitherto, had an open outcry trading system, switched over to a fully automated computerised mode of trading known as BOLT (BSE On Line Trading) System. It facilitates more efficient processing, automatic order matching and faster execution of trades. Above all, the system is more transparent for investors, while allowing members to keep their clients' positions confidential as compared to the earlier regime where the counterparty was always known. The members now enter orders/quotes on the Trader Work Stations (TWSs) in their offices instead of assembling in the trading ring. The trading system of The Stock Exchange, Mumbai also provides more or less the same features as those provided by the trading system of the National Stock Exchange.

17.2.12 Depositories and Dematerialisation

The entire transaction of purchase or sale of securities can be said to be completed only after the buyer becomes the rightful owner of the securities and the seller gets the sale consideration. Traditional settlement system on the Indian stock markets gave rise to settlement risk due to the time that lapsed before trades were settled. Further, transfer of securities involved sending the same along with sellers' endorsement on transfer deed for registration to the issuer. In many cases, the process took much longer than two months and significant proportion of transactions ended up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant and in addition to the issuers right to refuse the transfer of security. To obviate these problems, the Depositories Act, 1996 was enacted to provide for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by:

- (a) making securities of public limited companies freely transferable subject to certain exceptions;
- (b) dematerialising the securities in the depository mode; and
- (c) providing for maintenance of ownership records in book entry form.

In order to streamline both the stages of settlement process, the Depositories Act, 1996 envisaged transfer of ownership of securities electronically by book entry without making the securities moving from person to person. The Act made the securities of public limited companies freely transferable by restricting the company's right to use discretion in effecting the transfer of securities, thus, dispensing with the transfer deed and other procedural requirements under the Companies Act.

In a depository system, securities are held in securities (depository) accounts; which are more or less similar to holding funds in bank accounts. Transfer of ownership of securities is done

17.8 Advanced Auditing and Professional Ethics

through simple account transfers.

Advantages of Depository Services -

- (i) High liquidity of scrips due to immediate transfer and registration.
- (ii) Receive bonus and right as direct credit to the account thereby eliminating the risk of loss in transit.
- (iii) Much lower risk of bad deliveries.
- (iv) Reduction in brokerage.
- (v) Saving of stamp duty worth 1% of transaction price.
- (vi) Saving of courier, notary charges.
- (vii) Saving of expenses to be incurred on obtaining duplicate certificates as no threat of original shares getting mutilated or misplaced.

17.2.13 Depositories in India

National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) provide depository services to investors and clearing members through Depository Participants (DPs). They do not charge the investors and clearing members directly but charge their DPs, who are free to have their own charge structure for their clients. The charges for the investors are, therefore, market determined.

17.2.14 Clearing and Settlement Mechanism

When a trade has been executed, the shares and money should be transferred to the respective parties on settlement date. When an investor enters into a transaction with a broker, shares or funds, as the case may be, are delivered to the broker. In turn, the broker delivers these on settlement day to the settlement agent. In BSE, the settlement agent is known as 'Clearing House (CH)' whereas in NSE it is 'National Securities Clearing Corporation Ltd. (NSCCL)'.

Settlement of trades transacted on an Exchange requires smooth, preferably instantaneous, movement of securities and funds in accordance with the prescribed schedule of pay-in/pay-out. Movement of securities has become almost instantaneous in the dematerialised environment. Two depositories, namely, National Securities Depository Limited and Central Depository Services Limited, are in place to provide electronic transfer of securities. All actively traded scrips are held, traded and settled in demat form. The securities pay-in obligations of members / custodians are downloaded by the clearing agency. The members / custodians make available the required securities in their pool accounts with Depository Participants (DPs) by the prescribed pay-in time for securities. The depository runs an electronic file to transfer the securities from the pool accounts of members / custodians with DPs to the DP account of the clearing agency. As per the allocation schedule determined by the clearing agency, the securities are transferred on the pay-out day by the depository from the DP account of the clearing agency to the DP accounts of members / custodians. In case of trades settled under account period settlement, the pay-out of securities are effected on the same day in case of trades settled under rolling settlement. The ownership vests with the buyer as soon as the securities move from DP account of the member /

custodian to his DP account.

SEBI has directed that the brokers can issue contract notes authenticated by means of digital signatures, provided the broker has obtained the digital signature certificate from Certifying Authority under the IT Act, 2000.

Select banks have been empanelled by clearing agency for electronic transfer of funds. The members are required to maintain accounts with any of these banks. The members are informed electronically of their pay-in obligations of funds. The members make available required funds in their accounts with clearing banks by prescribed pay-in day.

The securities can move instantaneously from the seller to seller's broker to clearing agency to buyer's broker to buyer since all these have accounts with either of the two depositories which are connected to most of the Stock Exchanges. The depositories have been obligated under the Depositories Act, 1996 to transfer securities electronically.

17.2.15 Disclosure of Proprietary Trading by Broker to Client

With a view to increase the transparency in the dealings between the broker and the client, SEBI has directed that every broker shall disclose to his client whether he does client based business or proprietary trading as well. The broker shall disclose this information to his existing clients within a period of one month from the date of this circular. Further, the broker shall disclose this information upfront to his new clients at the time of entering into the Know Your Client agreement. In case of a broker who at present does not trade on proprietary account, chooses to do so at a later date, he shall be required to disclose this to his clients before carrying out any proprietary trading.

17.3 Rolling Settlement

A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within "X" business days from the transaction date. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis (T+2). The transactions in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis, i.e., both pay-in and pay-out of monies and securities for transactions in scrips on transaction day (T day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e., the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In other words, if an investor buys and sells X no. of shares on the same day then he shall first have to actually deliver and then receive the securities on the settlement day.

17.10 Advanced Auditing and Professional Ethics

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips with effect from July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further, the mark-to-market differences are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the Exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the Exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- ◆ Highest price recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction.

OR

- ◆ 20% above the closing price on a day prior to the auction.

In this case, the auction price/close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction /close out price is less than sale price, the difference is not given to the seller but is credited to Investor Protection Fund.

17.4 Derivatives

Derivative is a security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset.

17.4.1 Derivatives Market at NSE

The derivatives trading on the NSE commenced with S&P CNX Nifty Index futures on 12th June, 2000. The futures contract on NSE is based on S&P CNX Nifty Index. Currently, it has a maximum of 3 month expiration cycle. Three contracts are available for trading, with 1 month, 2 months and 3 months expiry. A new contract is introduced on the next trading day following the expiry of the near month contract.

The Futures and Options trading system of NSE called NEAT-F&O trading system, provides fully automated screen based trading for S&P CNX Nifty futures on a nationwide basis and an online monitoring and surveillance mechanism. The NEAT-F&O trading system is accessed by two types of users. The Trading Members (TM) have access to functions such as, order entry, order matching, order and trading management. The Clearing Members (CM) uses the trader workstation for the purpose of monitoring the trading members for whom they clear the trades. Additionally, they can enter and set limits to positions, which a trading member can take.

There are Two Types of Clearing Members

- ◆ Trading Member Clearing Member (TM-CM) is a CM who is also a TM. TM-CM may clear and settle his own proprietary trades and clients' trades as well as clear and settle for other TMs.
- ◆ Professional Clearing Members (PCM) is a CM who is not a TM. Typically banks and custodians could become a PCM and clear and settle for TMs.

Nifty index futures contracts are cash settled on a daily basis by marking to market all open positions on the basis of the daily settlement prices. Members are required to pay the mark to market losses by T+1 day and the same is in turn paid to the members who have made a profit. The contracts are finally settled on expiry of Nifty index futures contract, when NSCCL marks the open positions of a CM to the closing price of underlying index and resulting profit / loss is settled in cash.

For settlement purposes, the daily settlement price is the closing price of futures contract. Trading in Index Options and Stock Futures & Options has also been introduced in Derivatives Segment of NSE.

17.4.2 Derivative Trading at BSE

The derivatives trading on the BSE commenced with BSE Sensitive Index futures on 9th June, 2000. The futures contract on BSE is based on BSE Sensitive Index (Sensex). The trading and settlement mechanism is more or less on the same lines as in NSE. However, for settlement purposes, the daily settlement price is calculated as the weighted average price of trades during the day. Trading in Index Options and Stock Futures & Options has also been introduced in Derivatives Segment of BSE.

17.5 Circuit Filters or Circuit Breakers

Circuit Breakers or circuit filters are the price bands that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading day's closing. SEBI has directed the exchanges to apply circuit filters on scrips traded in Rolling Settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However, feeling the threat of high settlement default in scrips forming part of sensex or in which derivatives and futures are available, because of these filters, SEBI has restricted the fluctuation to 10% instead of 20%.

Price bands restrict extreme price movements and thereby resist price manipulation. These protect investors from extreme fluctuations in a panic market created by rumours and short term fears.

Market Wide Circuit Breakers (MWCB) - Market wide circuit breakers do the same job for the entire market what circuit filters do for individual scrips. MWCB has been introduced to control excessive market movements in BSE sensex and Nifty. SEBI has introduced MWCB at 10-15-20% of the movements in these indices. The stock exchange on a daily basis shall translate the 10%, 15% and 20% circuit breaker limits of market-wide index variation based on the previous day's closing level of the index. These breakers provide the time to participants to

17.12 Advanced Auditing and Professional Ethics

react to the movement by way of the trading halt. Additionally, a 15 minutes pre-opening session post each trading halt has been introduced vide SEBI Circular dated September 3, 2013. The auditor need to ensure the compliance of the trigger limit, trigger time, halt duration and pre-opening session duration post each halt.

17.6 Accounting for Stock Exchange Transactions

A trading member is required to keep proper records and accounts for securities and monies receivable from and payable / transferable to both his clients as well as the Stock Exchange. The trading member is firstly required to enter the order into an Electronic Order Entry Book which then transfers the order to the Stock Exchange's trading system. As soon as the same is matched by a corresponding order by another trading member, the trade is said to be confirmed. A trading member is then required to pay margins (Mark-to-Market, Volatility, Gross Exposure) which are required to be collected from respective clients, wherever applicable). Since it is not feasible to collect margins from a client on a frequent basis, the trading member, generally, collects sufficient margin against each transaction at the point of execution of transaction. This margin is finally adjusted against outstandings in case of settlement of buy positions. If the client fails to pay for the securities purchased, the margin is used to take delivery and subsequently adjust the loss incurred in squaring off the transaction. In case of execution of sale order, the entire margin is refunded back alongwith the sale value of securities (net of brokerage and other costs) after the funds pay-out is received for securities delivered by the client. In case, the client fails to deliver the securities, the securities are required to be bought by the selling trading member to deliver to the buying trading member through auction. The margin is then used to adjust the loss on account of the difference between the buying price in auction and the price at which the security was original sold.

No entry is required to be passed by the trading member at the time of entering the order in Order Entry Book. Again on execution of trade, no entry is required to be passed in the books of accounts. All the transactions of each client are cumulated for an entire settlement before passing the entries in the ledger. However, it may be possible that a client may have made only one transaction in a given settlement.

Presuming that the client Mr. A (Client Code A0001) is the only client of the member for Rolling Settlement No. 200102151 and has done the following transactions in the said settlement -

Bought / Sold	Qty	Scrip Name	Transaction Rate (₹)	Brokerage @ 1% (say) (₹)	Effective Rate (₹)	Total Value (₹)
Bought	10	Infosys Technologies	3,000	30	3,030	30,300
Bought	100	TISCO	100	1	101	10,100
Sold	100	Reliance Industries	300	3	297	-29,700

In the above case, it may be noted that the client has to pay ₹ 10,700/- to the trading member. The trading member earns a brokerage of ₹ 700/- (i.e. $10 \times 30 + 100 \times 1 + 100 \times 3$) and is required to pay ₹ 10,000/- ($10 \times 3000 + 100 \times 100 - 100 \times 300$) to the Clearing Corporation/Clearing House towards his outstanding position for the settlement. The trading member would also have to add 5 % as service tax on brokerage earned amounting to ₹ 35/- on the net settlement position which is required to be paid to the Service Tax authorities.

It may be noted that the gross value of transactions done in the abovementioned example is ₹ 70,000/- (i.e. $10 \times 3000 + 100 \times 100 + 100 \times 300$). Considering the margin requirement @ 10% on gross value of transactions done, the trading member may collect ₹ 7,000/- from the client and for onward remittance to the Clearing Corporation / Clearing House.

In case, the client is unable to deliver the securities sold on the securities pay-in date, the same are auctioned by the Exchange (Auction Settlement Type A). This means that the Exchange allows any other Trading Member or his Client (through the Trading Member) bid for delivering the same. The client who has not been able to deliver the securities is required to treat the same as a buy order in his behalf and is bound to pay for the same.

Thus, if Mr. A (through his Trading Member) was unable to deliver 100 shares of Reliance Industries Ltd. on or before the pay-in day for securities and these shares were auctioned at a rate of ₹ 320 each, a fresh purchase entry would be passed in the books while no effect would be given to the original sales.

In case there are no bidders for selling the securities in an auction settlement for a particular auction scrip and quantity, then the original sale is closed out by squaring as per the rules of the Exchange. The entries nevertheless remain the same.

In case any amount is charged by the Exchange or clearing house towards any pay-in or pay-out defaults, the same is debited and collected from the client to the extent attributable to default committed by the client. The Member is also liable to pay transaction charges and various other charges, fines, interest, etc. to the Exchange or Clearing Corporation / Clearing House which along with other expenses are directly debited to the profit & loss account through respective expense accounts.

17.7 Conduct of Audit

As stated earlier, in exercise of the powers vested in the Central Government under Rule 12 of the Securities Contracts (Regulation) Rules, 1957, the Government issued a notification dated 29th January, 1983 requiring the accounts of active members of stock exchanges to be audited by chartered accountants. The audit comes into effect from the financial year commencing after 31st March, 1984 as per the Notification dated 11th January, 1984. Thus, accounts of members in respect of the financial years beginning on and after 1st April, 1984 are required to be audited by chartered accountants. Subsequent to the corporatisation of the Members of Stock Exchanges, statutory audit is now required under the Companies Act.

17.7.1 The Nature and Scope of the Audit

It has been clarified by the Government, vide its letter dated 31st May, 1984, that a member of

17.14 Advanced Auditing and Professional Ethics

the stock exchange, irrespective of the size of his business, would be considered 'active' for the purpose of audit if he has conducted business in securities even for a single day in the accounting year. The same letter also clarifies that the annual audit of accounts of a member of a stock exchange will be of the nature of the normal audit, as is conducted in the case of companies, co-operative societies and other entities. It will also hold good for the audits governed under the Companies Act.

Rule 12 of the Securities Contracts (Regulation) Rules, 1957 provides that "Every member shall get his accounts audited by a chartered accountant whenever such audit is required by the Securities and Exchange Board of India".

A sole proprietor, partnership firm, a corporate body and a financial institution also become members of the stock exchanges. Such members may get their financial statements audited under the statute governing them. For example, a company which is a member of a stock exchange would get its accounts audited under the provisions of the Companies Act, 2013. The members of stock exchanges may also get their accounts audited under the Income Tax Act, 1961.

17.7.2 The Books of Account and Other Documents subject to the Audit

According to the notification, audit is intended to cover the books of account and other documents specified under Securities Contracts (Regulation) Rules, 1957 and SEBI (Stock Brokers and Sub-Brokers) Rules, 1992. The members of the Exchange are required to maintain the following books of accounts and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:

- ◆ Register of Transactions (Sauda Book) / Daily Transaction List
- ◆ Clients Ledger
- ◆ General Ledger
- ◆ Journals
- ◆ Cash Book
- ◆ Bank Pass Book
- ◆ Documents Register/Inward-Outward Register showing full particulars of shares and securities received and delivered
- ◆ Members' contract book showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other member
- ◆ Counterfoils or duplicates of contract notes issued to clients
- ◆ Written consent of clients in respect of contracts entered into as principals
- ◆ Margin Deposit Book
- ◆ Register of accounts of sub-brokers

- ◆ An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock-broker and such sub-brokers
- ◆ An agreement with the sub-broker and with the client of the sub-broker to establish privity of contract between the stock broker and the client of the sub-broker.

In addition to the above statutory requirements, the Exchange as per its rules, regulations and bye-laws, may also require their Members to maintain the following records / documents-

- ◆ Copies of all margin statements downloaded from the Exchange.
- ◆ Copies of Settlement / Valan Balance Sheet along with all relevant sheets.
- ◆ Details of Spot Delivery transactions entered into (including securities delivered and payments made to the members)
- ◆ Client database & Broker Client Agreement.
- ◆ Copy of Registration Certificate of each Sub-broker issued by SEBI.
- ◆ Copy of approval for each Remisier given by the Exchange.
- ◆ Copy of the Power of Attorney/Board Resolution authorizing Directors/employees to sign the Contract Note.
- ◆ Copies of Pool Account Statements.

If a member of the Stock Exchange also holds' membership of any other recognized Stock Exchange or in a different segment of the same Exchange, (e.g., Derivatives Segment) then such member is required to maintain a separate set of books of accounts, records and documents for trades executed on each recognized stock exchange or each segment of the exchange. The auditor should verify whether the member is maintaining all the above books, documents, etc. and they are up to date.

Considering the extent of computerisation at the level of Stock Exchange as well as at member's end, an auditor may determine the extent and depth of verification of the audit. For this, the auditor needs to study and understand the various manual and computerised accounting processes employed by the Member and various controls and checks embodied therein. On the basis of same and the materiality thereof, the auditor may decide his audit procedures, extent of checking required and exercise his diligence for the purpose of reporting. Some of the important books of accounts, documents and relevant auditing procedures / tests are discussed below.

17.7.3 Daily Transactions List (Sauda Book) / Register of Transactions

All members are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained datewise. This register contains all the transactions, which may be of any of the kind mentioned below:

- ◆ member's own business on the Exchange

17.16 Advanced Auditing and Professional Ethics

- ◆ member's business on the Exchange on behalf of clients
- ◆ member's business with the clients on principal-to-principal basis
- ◆ member's business with the members of other Stock Exchanges
- ◆ member's business on behalf of his clients with the members of other Stock Exchanges
- ◆ Spot transactions, etc.

17.7.4 Contract Notes

Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The contract notes are required to be issued to the Client within 24 hours of execution of the trades. Members are also required to preserve counter-foils or duplicates of the copies of contract notes issued to clients. The member is also required to maintain written consent of clients for the contracts entered into as Principal. Contract notes issued to clients should show the brokerage separately. The total brokerage charged by the member should not exceed the specified value of the trade. It may be noted that the brokerage percentage is prescribed from time to time. The Contract Notes are required to be signed either by the member himself or his constituted attorney. In case of a sole proprietor / partnership firm wishes to authorise another person to sign the contract notes, then the member is required to submit a power of attorney to the Exchange. In case of corporate membership, a board resolution is required to authorise a person including Directors to sign the contract notes.

The member then prepares a Contract Note in the prescribed form after adding the brokerage and sends the original Contract Note to the client. The auditor should evaluate the internal control procedures instituted by the stock broker for proper maintenance and issuance of contract notes. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the clients. The auditor should verify the list of trades executed with the bills raised. The auditor should apply appropriate audit procedures to satisfy himself that -

- ◆ Contract notes have been serially numbered.
- ◆ No serial number has been left blank.
- ◆ Format of the Contract Note is as prescribed by the Regulations of the Exchange.
- ◆ Duplicate copies / counterfoils of contract notes are maintained.
- ◆ Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.
- ◆ Contract notes have been signed by an authorised person.
- ◆ Contract notes have been issued in respect of all transactions.
- ◆ Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.

- ◆ SEBI Registration number, Settlement number, Settlement dates have been mentioned.
- ◆ PAN number of the member and client has been mentioned on Contract Note where if required.
- ◆ All clauses specified by the Exchange have been printed on the reverse of the contract notes.

17.7.5 Service Tax

Service Tax on a member of a stock exchange had been introduced by the Government in union-budget 1994-95. Service tax is levied on the value of taxable services which shall be the gross amount charged by the service provider of such service provided or to be provided by him at the rate prescribed from time to time by the Government. Taxable Service has been defined u/s 65(105)(a) of the Act as any service provided to any person by a stock broker in connection with the sale or purchase of securities listed on a recognized stock exchange services provided by sub-brokers has also been brought into tax net by Finance (No.2) Act, 2004 w.e.f. 10.09.2004.

17.7.6 Security Transaction Tax (STT)

In the Union Budget for 2004-05, Government has introduced Securities Transaction Tax to be levied on all transactions done on stock exchange. As per the provisions of the Finance Bill, the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India. SEBI vide its Circular No.MRD/DOP/Cir-28/2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy collection and remittance of STT.

17.7.7 Client Bills

Client Bills represents the summary of all trades executed on behalf of the client during a particular settlement. It also reflects the net amount receivable or payable to the Member from / to the client. This amount is normally posted to the individual ledger account. The auditor may call for the bills for verification and check whether the same have been properly posted to client's ledger.

17.7.8 Clients Ledger

Every broker is required to maintain a clients' ledger. This ledger contains the details of the bills raised and the payment received from or made to the clients. As mentioned earlier, Client Ledger is required to be maintained separately for different Exchange or for different Trading Segment of the same Exchange. It may be noted that SEBI Rules provides that payment is to be made to the client within 24 hours of pay-out by the Exchange. He should further verify that the clients receipts / payments are made through designated "Client Bank Account" of the Member. It may be mentioned here that payments not made or received since a considerable period or the amount of payment made or received is consistently different for bills raised over a period of time in respect of some clients. These may represent some financial or accounting irregularity which would require further attention of the Auditor. The auditor may also scrutinise

17.18 Advanced Auditing and Professional Ethics

the client ledger to identify accounts whether loans or deposits received from a paid to the clients have been passed through this account. The client may also obtain from member clients the letters confirming their balances at the end of the financial year as appearing in his books of account on a test basis. Preferably, such letters of confirmation should be sent to the clients directly by the auditor. The auditor should carry out scrutiny of the accounts appearing in the Clients' Ledger with a view to ascertain the age of clients' accounts and in case of old debit balances for determining provision for bad and doubtful debts.

17.7.9 Settlement / Vallan Control Account

At the end of the settlement, Client Bills are posted to Client Ledger account as mentioned above. At the same time the net amount receivable from or payable to the Exchange, Clearing house is posted to the Settlement / Vallan Control Account. The payment made to / received from Clearing House for a particular settlement should match with the pay-in / pay-out entries. The auditor should verify that the balance in this account after his settlement should ideally be nil and in case of any balance in this account, the reconciliation statement from the member should be obtained.

17.7.10 Clearing House Bank Account

At the end of the settlement, the payment related to the pay-in or pay-out is routed through the Clearing House account. This account normally reflects the bank entries which are passed in the Clearing Bank account. The book balance in this account should be reconciled with the balance in Clearing Bank account as per bank statement.

17.7.11 Brokerage Account

At the end of the each settlement, brokerage income is credited to brokerage account appearing in general ledger. The auditor should verify whether brokerage is credited for each settlement or not, failing which the reasons thereof can be inquired into. The brokerage amount should be periodically reconciled with the amount on which the service tax has been paid as disclosed in service tax return. Since brokerage is the main source of income for members of stock exchanges, the auditor should pay particular attention to revenue recognition aspect. Brokerage income is recognised as income on the basis of principles laid down in Accounting Standard (AS) 9, Revenue Recognition.

17.7.12 Margin Deposit Book

A member is required to maintain a margin deposit book wherein details of all the margins deposited with the Clearing House are to be recorded. The book should be verified to ascertain whether the member has complied with all the directives regarding margins, etc. issued by SEBI or Stock Exchange from time to time. The margin payments made by the member may be cross-checked with the daily margin statements downloaded from the Stock Exchange.

The auditor should apply appropriate audit procedures to satisfy himself that margins have been properly calculated, collected and paid. The auditor should examine that margin deposit lying with the Clearing House are supported by the confirmation. The auditor should verify

whether adjustment entries relating to settlement margin and daily margin which is adjusted at the time of settlement are correctly passed or not. The auditor should also ensure that exemptions from payment of margins of Institutional Trades have been claimed correctly.

17.7.13 Members' Own Trading Account

Many a times, member of the Exchange executes the trade on his own behalf. In such cases, the entry related to trades is passed in the same way as it is done for a client. Members own trading account normally appears in general ledger. The auditor should verify the entries appearing in this account with respect to the bills raised for own account trading. The balance appearing in this account should be identified into profit or loss or closing stock-in-hand, as the case may be.

17.7.14 Bank Book

A member of a Stock Exchange is required to maintain separate bank account for the client's money and their own money. No payment for a transaction in which the member has traded on his own account shall be made from clients account. No money can be paid into clients account other than -

1. Money held or received on account of clients.
2. Money for replacement for any sum which may by mistake or accident drawn from the account.
3. A cheque or draft received from a client.

No money can be paid from client's account other than -

1. The money required for payment to the Clearing Corporation / House on behalf of clients.
2. Money for replacement for any sum which may by mistake or accident deposited into client account.

The auditor should verify the bank reconciliation statement for all the bank accounts in the usual manner.

17.7.15 Documents Register (Inward / Outward Register)

This register contains the particulars of the securities including their distinctive numbers received from or delivered to clients in a physical form by a member. This is a primary record, which lists and identifies every security available with the member at any given time. Generally, it is observed that members maintain a ledger, which contains only the number received, delivered and balance. This ledger does not provide for the distinctive numbers of the scripts received from or delivered to the clients. It may be mentioned that if distinctive numbers are not recorded properly then the identification of introducer cannot be established.

While scrutinizing this register, the auditor should analyse the balances of stock appearing in this register and segregate the same into client stock and own stock. The auditor should inquire the reasons for client's stock remaining with the Member. Further, the auditor may also, on a random basis, physically verify the stock available with a member in certain scrips, if so, desired.

17.20 Advanced Auditing and Professional Ethics

17.7.16 Maintenance of Books of Accounts and Other Documents

In terms of Rules 14 and 15 of Securities Contracts (Regulation) Rules, 1957, every recognized stock exchange and its members are required to maintain and preserve the specified books of account and documents for a period of five years. Further, as per regulation 18 of SEBI (Stock Brokers & Sub-Brokers) Regulation, 1992, every stock broker shall preserve the specified books of account and other records for a minimum period of five years.

17.7.17 Dematerialized Securities

On account of compulsory dematerialisation of most of the securities listed on the Exchange, all stock brokers are required to maintain two accounts with their Depository Participants (DP) for handling the receipt and delivery of securities in demat. One account is 'Beneficiary Account' wherein the demat securities belonging to the members' for their own account are held and the other is 'Pool Account' wherein the demat securities of the clients are temporarily lodged for transfer to/from the Clients / Clearing House in the Pay-in/Pay-out. In case of sale of securities by clients, the clients transfer the same in the demat form to the member's Pool Account to the Clearing House on the Pay-in day. In case of purchase of securities by the Client, the Clearing House transfers the securities to the Pool Accounts of the members and the members then transfer the same to the accounts of individual clients. The members are required to maintain a proper record of all shares received and delivered from their Pool Account as well as preserve acknowledged copy of the delivery instructions given to their DP's for transferring the securities from the Pool Account to the Clients' account after the Pay-out.

The auditor should verify whether the securities received by the member in the Pool Account are regularly transferred to the buying clients' Demat Accounts within 24 hours of declaration of Pay-out of the relevant settlement of the Exchange. It may be noted that Sometimes, the clients instruct the brokers to retain the shares in the Pool Account either because they have not opened a demat account or because they intend to sell the shares they have bought earlier, in the subsequent settlement and thereby avoid transaction charges. The auditor should check that the shares lying in the Pool Account have not been utilized by the member to meet his own pay-in obligations or used for meeting auction obligations. If the auditor discovers something like this then, he should further enquire into the matter. Such instances might indicate the breach of fiduciary trust by the member of the stock exchange.

Depending upon the nature of the business carried on by the member, the auditor may apply such procedural tests as he considers necessary on major items of income and expense such as, commission, sub-brokerage, underwriting income, interest and dividends, advisory fees, interest, amounts payable towards transactions charges and other charges to the Exchange or Clearing House and other income and expenses.

The auditor should apply analytical procedures on the financial statements of the member. The auditor should compare current operating results with those of the prior period to ascertain that the variations are logical in the circumstances such as volume of business at the stock-exchanges, the brokerage concern's share of the market, changed business conditions such as volume of new securities issued, changes in the character of the business of the brokerage concern, and trend prices of securities. A discussion of this comparative data

with the officials of the member may highlight areas where added audit emphasis may be directed.

17.8 Auditor's Report

As per the notification issued by the Government, an auditor should submit his report in the following form:

“We have audited the attached balance sheet of M/s. ABC as at _____ and the profit and loss account for the year ended on that date annexed thereto and report that:

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

In our opinion, proper books of account and records as specified in Rule 15 of the Securities Contracts (Regulation) Rules, 1957 have been kept so far as appears from our examination of such books.

The stock broker has complied with the requirements of the stock exchange so far as they relate to maintenance of accounts and was regular in submitting the required accounting information to the stock exchange.

The balance sheet and the profit and loss account referred to in this report are in agreement with the books of account.

In our opinion and to the best of our information and according to the explanations given to us, the said balance sheet and the profit and loss account read together with the notes thereon give a true and fair view insofar as it relates to the balance sheet, of the state of affairs of M/s. ABC, and insofar as it relates to profit and loss account, of the profit of M/s. ABC for the year ended on that date.”

According to clause (c) of the form of audit report prescribed by the Government, the auditor is required to report whether the member of the stock exchange had complied with the requirements of the stock exchange insofar as they relate to maintenance of accounts and that he was regular in submitting the required accounting information to the stock exchange. The auditor is therefore required to acquaint himself with the said requirements of the stock and / or the Ministry of Finance shall have a right to obtain a copy of the profit and exchange, if any.

The aforesaid Notification further requires that the audit should be completed within 6 months of the date of closing of the books of account. In individual cases, an extension for a period not exceeding 3 months may be granted by the concerned Executive Director / Secretary of the Stock Exchange if he is satisfied that adequate reasons exist for granting such an extension. The audit report should be made out in triplicate and addressed to the member of the Stock Exchange, who should submit quarterly, one of the copies of all audit reports received during the quarter to the Ministry of Finance within one month of the end of the quarter.

The audit reports to be submitted to the aforesaid authorities need not be accompanied by copies of the relevant profit and loss account and balance sheet. However, the said authorities

17.22 Advanced Auditing and Professional Ethics

have right to demand profit and loss account and / or balance sheet wherever they consider necessary.

It may be noted that in cases where the member is a company registered under the Companies Act, the reporting consideration that apply to other companies shall also apply to the member company. For example, the audit would have to necessarily make the assertions given in sub-section (2) and (3) of section 143 of the Companies Act, 2013.

Internal Audit for stock brokers/trading members/clearing members:

SEBI vide its Circular dated 21.10.2008 has decided that stock brokers/trading members/clearing members shall carry out complete internal audit on a half yearly basis by an independent qualified chartered accountants, company secretaries or cost and management accountants who are in practice and who do not have any conflict of interest.

17.9 Audit of Mutual Funds



SEBI (Mutual Funds) Regulations, 1996 provide that every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company. An auditor is a person who is qualified to act as an auditor under the Companies Act. The auditor shall be appointed by trustees. The auditor shall forward his report to the trustees and such report shall form part of the Annual Report of the mutual fund.

Fig.: Audit of Mutual Fund*

17.9.1 Proper Books of Account

The Regulations require that every asset management company for each scheme shall keep and maintain proper books of account, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the Board the place where such books of account, records and documents are maintained. Every asset management company shall maintain and preserve for a period of 8 years its books of account, records and documents. The asset management company shall follow the accounting policies and standards as specified in Ninth Schedule so as to provide appropriate details of the scheme wise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unit holder in a fair and true manner.

* Source: memeshappen.com

17.9.2 Audit Report

- (1) *Every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company.*

Explanation: For the purposes of this sub-regulation and regulation 66 – auditor means a person who is qualified to audit the accounts of a company as per the Companies Act.

- (2) *An auditor shall be appointed by the trustees.*
- (3) *The auditor shall forward his report to the trustees and such report shall form part of the Annual Report of the mutual fund.*
- (4) *The auditor's report shall comprise the following:—*
- (a) *a certificate to the effect that,—*
- (i) *he has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit;*
- (ii) *the balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the Fund for the accounting period to which the Balance Sheet or, as the case may be, the Revenue Account relates;*
- (iii) *the statement of account has been prepared in accordance with accounting policies and standards as specified in the Ninth Schedule.*

Below mentioned details of Audit Report is given in eleventh schedule on Annual Report and abridged summary as per SEBI (Mutual Fund) Regulation 1996:

- (i) *All mutual funds shall be required to get their accounts audited in terms of a provision to that effect in their trust deeds. The Auditor's Report shall form a part of the Annual Report. It should accompany the Abridged Balance Sheet and Revenue Account. The auditor shall report to the Board of Trustees and not to the unitholders.*
- (ii) *The auditor shall state whether:*
- (1) *he has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit,*
- (2) *the Balance Sheet and the Revenue Account are in agreement with the books of account of the fund.*
- (iii) *The auditor shall give his opinion as to whether:*
1. *the Balance Sheet gives a true and fair view of the schemewise state of affairs of the fund as at the balance sheet date, and*
2. *the Revenue Account gives a true and fair view of the schemewise surplus/deficit of the fund for the year/period ended at the balance sheet date.*

17.24 Advanced Auditing and Professional Ethics

17.9.3 Inspection and Audit

The SEBI has a right to conduct inspection and audit the books of account as per Regulation. Some of the regulations of the SEBI (Mutual Funds) Regulations, 1996 are discussed below:

Regulation 61: Board's right to inspect and investigate

The SEBI may appoint one or more persons as inspecting officer to undertake the inspection of the books of account, records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and asset Management Company for any of the following purposes, namely:

- (a) to ensure that the books of account are being maintained by the mutual fund, the trustees and asset management company in the manner specified in these regulations;
- (b) to ascertain whether the provisions of the Act and these regulations are being complied with by the mutual fund, the trustees and asset management company;
- (c) to ascertain whether the systems, procedures and safeguards followed by the mutual fund are adequate;
- (d) to ascertain whether the provisions of the Act or any rules or regulations made thereunder have been violated;
- (e) to investigate into the complaints received from the investors or any other person on any matter having a bearing on the activities of the mutual funds, trustees and asset management company;
- (f) to *suo motu* ensure that the affairs of the mutual fund, trustees or asset management company are being conducted in a manner which is in the interest of the investors or the securities market.

Regulation 62: Notice before inspection and investigation

- (1) Before ordering an inspection or investigation under regulation 61 the Board shall give not less than ten days notice to the mutual fund, asset management company or trustees as the case may be.
- (2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing direct that such inspection or investigation be taken up without such notice.
- (3) During the course of inspection or investigation, the mutual fund, trustees or asset management company against whom the inspection or investigation is being carried out shall be bound to discharge his obligations as provided in regulation 63.

Regulation 63: Obligations on inspection and investigation

- (1) It shall be the duty of the mutual fund, trustees or asset management company whose affairs are being inspected or investigated, and of every director, officer and employee thereof, to produce to the inspecting officer such books, accounts, records, and other documents in its custody or control and furnish him such statements and information

relating to the activities as mutual funds, trustees or asset management company, as the inspecting officer may require, within such reasonable period as the inspecting officer may specify.

- (2) The mutual fund, trustees or asset management company shall allow the inspecting officer to have a reasonable access to the premises occupied by it or by any other person on its behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the mutual fund, trustees and asset management company or such other person and also provide copies of documents or other materials which in the opinion of the inspecting officer are relevant for the purpose of the inspection.
- (3) The inspecting officer, in the course of inspection or investigation, shall be entitled to examine or record the statements of any director, officer, or employee of the mutual fund, trustees and asset management company.
- (4) It shall be the duty of every director, officer, or employee of the mutual fund, asset management company or trustee to give to the inspecting officer all assistance in connection with the inspection or investigation, which the inspecting officer may reasonably require.

The inspecting officer shall, as soon as possible, on completion of the inspection or investigation submit a report to the Board. He may also be required to submit an interim report if directed by the Board.

The SEBI has also the power in addition to normal audit, to appoint an auditor to inspect or investigate, as the case may be, into the books of account or the affairs of the mutual fund, trustee or asset Management Company:

Provided that the Auditor so appointed shall have the same powers of the inspecting officer as stated in regulation 61 and the obligation of the mutual fund, asset Management Company, trustee, and their respective employees in regulation 63, shall be applicable to the investigation under this regulation.

17.9.4 Ninth Schedule

As per Regulations 50(3), 55(4)(iii) to Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, extract of ninth schedule is reproduced below:

Accounting Policies and Standards

- (a) For the purposes of the financial statements, mutual funds shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income.
- (b) Dividend income earned by a scheme should be recognised, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments which are not quoted on the stock exchange, dividend income must be recognised on the date of declaration.

17.26 Advanced Auditing and Professional Ethics

- (c) In respect of all interest-bearing investments, income must be accrued on a day to day basis as it is earned. Therefore, when such investments are purchased, interest paid for the period from the last interest due date upto the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.
- (d) In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed.
- (e) Transactions for purchase or sale of investments should be recognised as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transaction should be recorded in the event of a purchase, as of the date on which the scheme obtains an enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.
- (f) Bonus shares to which the scheme become entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognised only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.
- (g) Where income receivable on investments has accrued but has not been received for the period specified in the guidelines issued by the Board, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by the Board.
- (h) When in the case of an open-ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative be debited to reserves, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.
- (i) In the case of an open-ended scheme, when units are sold and appropriate part of the sale proceeds should be credited to an Equalisation Account and when units are repurchased an appropriate amount should be debited to Equalisation Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalisation Account debited or credited to the Revenue Account should not decrease or increase the net income of the fund but is only an adjustment to the

distributable surplus. It should, therefore, be reflected in the Revenue Account only after the net income of the fund is determined.

- (j) In a close-ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 which provides to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortised initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.
- (k) The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's brought note. In respect of privately placed debt instruments any front-end discount offered should be reduced from the cost of the investment.
- (l) Underwriting commission should be recognised as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.
- (m) In case of real estate mutual fund scheme, investments in unlisted equity shares shall be valued as per the norms specified in this regard.

17.9.5 Non availability of Unit Premium Reserve for dividend distribution

The Ninth and Eleventh Schedule of SEBI (Mutual Funds) Regulations provide the accounting policies to be followed for determining distributable surplus and accounting the sale and repurchase of units in the books of the Mutual Fund. Thus, the format for Scheme Balance Sheet provides for disclosure of Unit Premium Reserve.

In this perspective, SEBI vide its Circular, dated March 15th, 2010, clarified that the Unit Premium Reserve, which is part of the sales price of units that is not attributable to realized gains, cannot be used to pay dividend. However, it is observed that some Mutual Funds are using Unit Premium Reserve for distribution of dividend. It is therefore reiterated that:

- a. When units of an open-ended scheme are sold, and sale price is higher than face value of the unit, part of sale proceeds that represents unrealised gains shall be credited to a separate account (Unit Premium Reserve) and shall be treated at par with unit capital and the same shall not be utilized for the determination of distributable surplus.
- b. When units of an open-ended scheme are sold, and sale price is less than face value of the unit, the difference between the sale price and face value shall be debited to distributable reserves and the dividend can be declared only when distributable reserves become positive after adjusting the amount debited to reserves as per para 2(a)(ix) of Eleventh Schedule of SEBI (Mutual Funds) Regulations.

17.10 Audit of Depositories



The SEBI (Depositories and Participants) Regulations, 1996 empower SEBI to conduct inspection and audit. The regulation requires that depositories shall have adequate mechanisms for the purposes of reviewing monitoring and evaluating the depository's controls systems, procedures and safeguards. Depositories are required to maintain the following records and documents, namely:

Fig.: Audit of Depositories *

- (a) records of securities dematerialised and rematerialised;
- (b) the names of the transferor, transferee, and the dates of transfer of securities;
- (c) a register and an index of beneficial owners;
- (d) details of the holding of the securities of beneficial owners as at end of each year.
- (e) records of instructions received from and sent to participants, issuers, issuers' agents and beneficial owners;
- (f) records of approval, notice, entry and cancellation or pledge or hypothecation, as the case may be;
- (g) details of participants;
- (h) details of securities declared to be eligible for dematerialisation in the depository; and
- (i) such other records as may be specified by the Board for carrying on the activities as a depository.

Every depository shall intimate the Board the place where the records and documents are maintained. Subject to the provisions of any other law the depository shall preserve records and documents for a minimum period of five years.

Where records are kept electronically by the depository, it shall ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that the records are not lost, destroyed or tampered with and in the event of loss or destruction, ensure that sufficient back up of records is available at all times at a different place.

Some of the regulations of the SEBI (Depositories and Participants) Regulations, 1996 relating to inspection or investigation are discussed below:

* Source : CS Mukesh H Shah

Regulation 59: Board's right to inspect

The SEBI has also the power to appoint one or more persons as inspecting officer to undertake inspection of the books of account, records, documents and infrastructure, systems and procedures, or to investigate the affairs of a depository, a participant, a beneficial owner an issuer or its agent for any of the following purposes, namely:

- (a) to ensure that the books of account are being maintained by the depository, participant, issuer or its agent in the manner specified in these regulations;
- (b) to look into the complaints received from the depositories, participants, issuers, issuers' agents, beneficial owners or any other person;
- (c) to ascertain whether the provisions of the Act, the Depositories, the bye-laws, agreements and these regulations are being complied with by the depository, participant, beneficial owners, issuer or its agent;
- (d) to ascertain whether the systems, procedures and safeguards being followed by a depository, participant, beneficial owners, issuer or its agent are adequate;
- (e) to *suo motu* ensure that the affairs of a depository, participant, beneficial owner, issuer or its agent, are being conducted in a manner which are in the interest of the investors or the securities market.

Regulation 60: Notice before inspection and investigation.

- (1) Before ordering an inspection or investigation under regulation 59, the Board shall give not less than 10 days notice to the depository, participant, beneficial owner, issuer or its agent, as the case may be.
- (2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing direct that such inspection be taken up without such notice.
- (3) During the course of an inspection or investigation, the depository, a participant, a beneficial owner, an issuer or its agent against whom the inspection or investigation is being carried out shall be bound to discharge his obligation as provided in regulation 61.

Regulation 61: Obligations on inspection by the Board.

- (1) It shall be the duty of the depository, a participant, a beneficial owner, an issuer or its agent whose affairs are being inspected or investigated, and of every director, officer and employee thereof, to produce to the inspecting officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities as a depository, a participant, a beneficial owner, an issuer or its agent, as the inspecting officer may require, within such reasonable period as the inspecting officer may specify.
- (2) The depository, a participant, a beneficial owner, an issuer or its agent shall allow the inspecting officer to have reasonable access to the premises occupied by him or by any other person on his behalf and also extend reasonable facility for examining any books,

17.30 Advanced Auditing and Professional Ethics

records, documents and computer data in the possession of the depository, a participant, a beneficial owner, an issuer or its agent or such other person and also provide copies of documents or other materials which, in the opinion of the inspecting officer are relevant for the purposes of the inspection.

- (3) The inspecting officer, in the course of inspection of investigation, shall be entitled to examine or to record the statements of any director, officer or employee of the depository, a participant, a beneficial owner, an issuer or its agent.
- (4) It shall be the duty of every director, officer or employee of the depository, a participant, a beneficial owner, an issuer or its agent to give to the inspecting officer all assistance in connection with the inspection, which the inspecting officer may reasonably require.

The inspecting officer shall, as soon as possible, on completion of the inspection or investigation submit a report to the Board. He may also be required to submit an interim report if directed by the Board.

Further the SEBI has power to appoint an auditor to inspect or investigate, into the books of account, records, documents, infrastructures, systems and procedures or affairs of a depository, a participant, a beneficial owner, an issuer or its agent:

Provided that the auditor so appointed shall have the same powers of the inspecting or investigating officer as stated in regulations 59 and 60, and the obligation of the depository, participant, beneficial owner, issuer or its agent and their respective directors, officers and employees, as the case may be, as stated in regulation 61, shall be applicable to the inspection or investigation under this regulation.

Return of deposits to be filed with the Registrar: Rule 16 of the Companies (Acceptance of Deposits) Rules, 2014 requires, every company to which these rules apply shall, on or before the 30th day of June of every year, file with the Registrar, a return in the prescribed Form along with the specified fee and furnishing the information contained therein as on 31st day of March of that year, duly audited by the auditor of the company.

17.11 Environmental Auditing

Environmental reporting is the term now commonly used to describe the disclosure by an entity of environmentally related data, verified (audited) or not, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity) via either-

- (a) the annual report and accounts package;
- (b) a stand-alone corporate environmental performance report (CER);
- (c) a site-centered environmental statement; or
- (d) some other medium (e.g. staff newsletter, video, CD ROM, internet site)

Environmental audits are becoming increasingly common in certain industries. The term "environmental audit" has a wide variety of meanings. They can be performed by external or

internal experts (sometimes including internal auditors), at the discretion of the entity's management. In practice, persons from various disciplines can qualify to perform "environmental audits". Often the work is performed by a multi-disciplinary team. Normally, "environmental audits" are performed at the request of management and are for internal use.

In Indian scenario, the Regulatory Authorities like Ministry of Environment and Forest (MOEF), State Pollution Control Board (SPCB), State Department of Environment (SDOEn.) etc., have come into play to clear the projects from environmental viewpoint before it's commissioning. The Environmental Impact Assessment (EAI) is a pre-requisite to start an industry. The EAI tries to forecast the expected damage to be caused by the development of the industries to the environmental and the means required to mitigate that damage, incorporating the same in the Project Report for compliance in due course, keeping in view the serious threat to all the living beings in the universe by the rapid industrialisation which is polluting the environmental on an irreparable extent. The Indian Govt. notified by GSR No.329E dated 13.02.1992 that "Every person carrying on an industry, operation or process requiring consent under Section 25 of the Water (Prevention and Control of Pollution) Act, 1974 (6 of 1974) or under Section 21 of the Air (Prevention and Control of Pollution) Act, 1981 (4 of 1981) or both or authorisation under the Hazardous Waste (Management and Handling) Rules, 1989 issued under Environment Protection Act, 1986 (29 of 1986) shall submit an environment audit report for the financial year ending the 31st march in form V to the concerned State Pollution Control Board on or before the 15th day of May every year, beginning 1993".

With a view to define the Environmental Audit, it may be stressed that it is a critical analysis of (i) policies (ii) principles (iii) systems (iv) procedures (v) practices and (vi) performances of the aspect which relates the environment.

But a standard scope of Environmental Audit, as ought to be defined and adopted by standard companies, should be as follows:

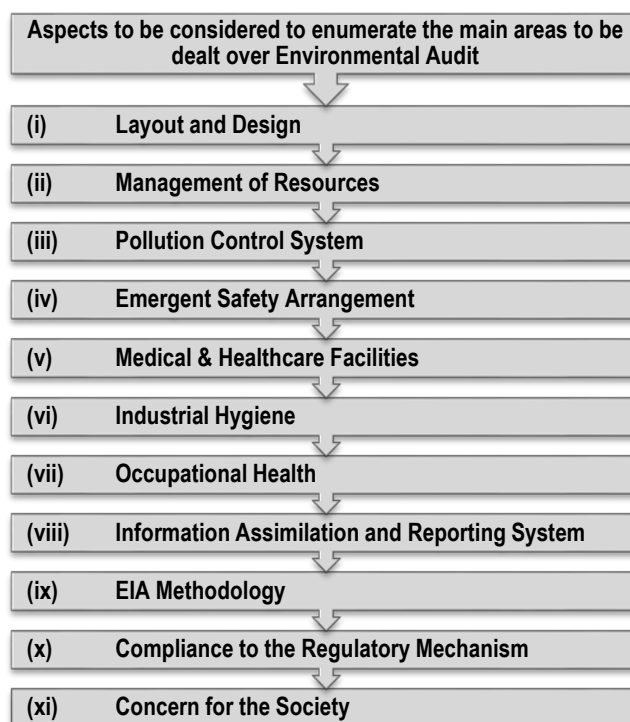
"A management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organisation, management and equipment are performing with the aim of helping to safeguard the environment by:

- (i) Facilitating management control of environmental Process.
- (ii) Assessing compliance with company policies, which would include meeting regulatory requirements".

The objective of the Environmental Audit are to evaluate the efficacy of the utilisation of resources of man, machines and materials, and to identify the areas of environmental risks and liabilities and weakness(es) of management system and problems in compliance of the directives of the regulatory agencies and control the generation of pollutants and/or waste.

As the Environmental Audit, especially in India, is still in its infancy the information usually gathered in the course of Environmental Audit is only what is required for the compliance of the statutory requirements, i.e., for Water Act, 1974, Air Act, 1981, etc., and for environmental clearance required before establishing an industry.

If it is to enumerate, what should be the main areas over which the Environmental Audit should be dealt, the following aspects are to be considered in respect of various industrial units:



- (i) **Layout and Design** – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for up-gradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the areas which requires attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.
- (ii) **Management of Resources** – Management resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.
- (iii) **Pollution Control System** – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping ill view the type of industry and its nature of working with respect to its grade of polluting the environment.
- (iv) **Emergent Safety Arrangement** – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the while. The emergency plans are to be reviewed periodically, sufficient staff along with other required

safety amenities should be kept ready. The staff, remained so engaged, must possess the required awareness and alertness to meet the contingency. The degree of awareness, however, can be upgraded with proper training provisions.

- (v) **Medical & Healthcare Facilities** – The medical services should be maintained. The health of the workers should be a big consideration for the management.
- (vi) **Industrial Hygiene** – Proper system should be in vogue to eliminate industrial unhygienic state.
- (vii) **Occupational Health** – The requirement for safeguarding against occupational health hazards should be available for all the workers. As the occupational health hazards varies from industry to industry due to the difference in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.
- (viii) **Information Assimilation and Reporting System** – The information system should be strengthened to generate and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular intervals.
- (ix) **EIA Methodology** – The Environmental Impact Assessment (EIA) is usually are pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.
- (x) **Compliance to the Regulatory Mechanism** – As the persons who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of stipulations and standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/owner vulnerable to prosecution and penalty.
- (xi) **Concern for the Society** – The industry very often transforms the agrarian environment into an industrial environment. The people so displaced by industrialisation feel alienated and develop a feeling of facing the gaseous, dustful, clumsy state of surroundings. The audit should look into this aspect how the industry is making a balance between its own development and the society's concern.

17.11.1 Audit Procedure

The small or medium unit does not call for an elaborate and/or formal system, but somebody is to be given charge to look after the matter. But when the concern is a big one, it needs a well planned system.

17.34 Advanced Auditing and Professional Ethics

The audit is to be conducted at regular interval, and internal audit system should also be supplemented to review the efficiency, effectiveness and to identify the training requirements of the audit staff.

17.11.2 Audit Format

The following are the main aspects which may be covered in the probable format of "Environmental Statement".

- (a) Name and address of the owner/occupier of the industry, operation or process.
- (b) Date of last environmental audit report submitted.
- (c) Consumption of water and other raw materials as input during current and previous year.
- (d) Pollution generated in air and water along with the output and the types of pollutants and the deviation from standard.
- (e) Generation of hazardous waste (in line with the Hazardous Waste Management and Handling Rules, 1989) in current year and previous year from processes or from pollution control facility.
- (f) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or re-utilisation of waste, etc.
- (g) The disposal practice for different type of waste.
- (h) The practice sorted for conservation of natural resources.
- (i) The additional investment proposal for environmental protection including abatement of pollution.

17.12 Energy Audit



Energy shortage and the cost of environmental quality control have made the use of energy very costly to many industrial establishments. As a result, many factories have opted for establishing energy management programmes to cope with severe energy shortages and for improving the profitability of their operations. Energy management involves the following basis approaches:

Fig.: Save Energy*

- (i) Reducing avoidable losses,
- (ii) Improving the effectiveness of energy use, and
- (iii) Increasing energy use efficiency

* Source : Alpha Techno Solution

No matter what approach is taken, the steps to be followed are general in nature, e.g., conduct energy audits, implement the energy conservation measures, carry out post installation monitoring and set targets, etc.

Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. It is the first step of any energy management programmes. The function of an energy auditor could be compared with that of a financial auditor. At the moment, while energy auditor is not yet a mandatory requirement on an all-India basis, the financial auditor is a pre-requisite for any organisation. Another key distinction is that the energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:

- (i) Quantify energy costs and quantities.
- (ii) Correlate trends of production or activity to energy costs.
- (iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
- (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
- (v) Highlight areas that need attention for detailed investigations.
- (vi) Conduct preliminary and detailed energy audits which should include the following:
 - (a) Data collection and analysis.
 - (b) Measurements, mass and energy balances.
 - (c) Reviewing energy procurement practices.
 - (d) Identification of energy efficiency projects and techno-economic evaluation.
 - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
 - (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

Energy efficiency is achieved through company-wide activities involving administration, purchase, design, engineering, production and maintenance management functions. Since it is an inter-disciplinary activity, energy efficiency must be supported not only by technical division but all other divisions as well. Therefore, in industries where energy cost is substantial or widely dispersed across the plant campus, it has been the experience of some large companies to set up internal energy audit teams. One of the effective ways of setting up an internal energy audit team is to have representation from the various sections with rotating membership and with atleast one team member from the area being audited. The eyes of a stranger very often see things which familiarity has made common place and invisible to the user of the area. To be truly effective, these audits must be made not only during normal working hours but also during night shifts, weekends and holidays.

17.12.1 Approach to Energy Auditing

The starting point for energy analysis of a factory would be to assess its past performance. The energy manager should first establish the energy efficiency indicator of the factory. To obtain this, the simplest approach is to consider the overall factory as a “black box” and identify the different forms of energies going into the boundary and the products leaving it over a given time period. Thus the evolution in the consumption of these energy inputs and the production rate can be derived. From these, the variation in the specific energy consumption (energy consumed per unit production) with time and production rate can be established. These figures can be compared with the average values or those pertaining to the best practices for similar industries in order to assess the comparative performance of the plant. It is found that there is indeed any scope for reduction in the specific energy consumption, one has to perform preliminary and/or detailed energy audit for analysing the different utility areas where these energies are to be converted into the final forms required by the production processes. The different phases of energy auditing in an industry are given below. All three phases can be included in a single audit or they can be conducted separately, depending on the size of the factory or facility under investigation.

- (i) Analysis of historical energy consumption and cost data.
- (ii) Preliminary energy audit, with the objectives to identify:
 - Major energy consuming equipment and processes.
 - Obvious inefficiencies and energy wastes.
 - Priority areas for further detailed investigation.
- (iii) Detailed technical and economic analyses of energy efficiency measures, especially those involving large capital investment or long payback periods.

17.13 Audit of Accounts of Non-Corporate Entities (Bank Borrowers)

The Reserve Bank of India (RBI), keeping in view the need for bringing discipline in the matter of maintenance of accounts by non-corporate entities, has issued a circular dated 12th April, 1985 to all Banks recommending audit of accounts of all non-corporate borrowers enjoying working capital limits of ₹ 10 lacs and above from the banking system.

For the purpose of computing the above limit, the term borrowing will include borrowing of the following types:

- (i) Packing credit facilities
- (ii) Cash credit facilities
- (iii) Loans-secured and unsecured
- (iv) Overdraft
- (v) Deferred payment facilities
- (vi) Guarantees:

- (a) Performance guarantees
- (b) Financial guarantees
- (vii) Bill Discounting Facilities
- (viii) Any other credit facilities (other than loans, guarantees, letter of credit etc.).

This requirement applied in respect of the accounting year of the non-corporate entity commencing on or after 1-4-1984. It is necessary for the non-corporate entity enjoying such credit facility to submit the audited statements and audit report to the concerned bank as early as possible but in any case not later than 6 months from the close of the accounting year. The primary responsibility for maintenance of books of accounts and records is that of the non-corporate entity.

17.13.1 Audit Procedure

- (i) The auditor is required to express his opinion as to whether the financial statements give a true and fair view of the state of affairs of the entity. For this purpose the auditor has to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require. Considering the contents of the audit report the auditor has to conduct the audit by applying the same principles which are applicable for an audit in the corporate sector. The audit report is to be given to the lending bank and therefore such report will be in the nature of a special purpose report.
- (ii) If he finds that there is no internal control, it would not be advisable for him to conduct the audit by applying test checks. The auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case.
- (iii) Section 143 of the Companies Act gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. In the case of audit of a non-corporate entity, it would be in the interest of the entity to furnish all the information and explanations and produce books of accounts and records required by the auditor. If, however, the entity refuses to produce any particular record or to give any specific information or explanation the auditor would be required to report the same and qualify his report.
- (iv) The non-corporate entity is free to choose any practising Chartered Accountant to conduct this audit. In the event of any such change it is necessary for the incoming auditor to communicate with the outgoing auditor as explained in the Institute's publication "Code of Ethics". He should also ensure that he does not resort to undercutting while accepting any such assignment.
- (v) As already noted, the primary responsibility for maintenance of books of account and records and that for preparation of financial statements is of the non-corporate entity. The auditor should obtain the letter of engagement and list of books of account and other records maintained by the entity before undertaking the audit assignment.
- (vi) Non-corporate entities are, in certain cases; evidenced by documents/agreements, such as, partnership deed, deed of association, trust deed etc. It would be necessary for the

17.38 Advanced Auditing and Professional Ethics

auditor to check the compliance with the terms of documents, agreements, so far as they relate to accounts and audits and to report all material violations of such terms.

- (vii) The figures of the immediately preceding year should be given in a manner so as to enable meaningful comparison. If the accounts of such preceding year are not audited, the fact should be indicated by way of a note and also reported by the auditor.
- (viii) The audited accounts should clearly disclose the results of the working of the entity for the year, every material feature, transactions of an exceptional and non-recurring nature and also transactions pertaining to earlier years, if material. The said accounts should be prepared in conformity with the generally accepted accounting principles followed consistently. Any deviation, if material, either from the accepted principles or from the policy/treatment followed in the preceding year should be clearly brought out in the notes and/or the Auditors' Report.
- (ix) The overall consideration should be that the financial statements so prepared should give a true and fair view of the working of the entity. Moreover, these statements should also assist the lending bankers in their evaluation of the loan proposals and in ensuring strict financial discipline, coupled with uniformity, in the existing as well as prospective customers.

17.13.2 Special Audit Report

A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis.

The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

In the quarterly special audit report, the auditor will have to give information relating to the operating data for each quarter. This information will have to be classified in the following manner:

- (i) Actual production;
- (ii) Actual production as a percentage of rated capacity;
- (iii) Sales;
- (iv) Cost of goods sold/cost of production;
- (v) Gross margin;
- (vi) Interest on bank borrowing; and
- (vii) Interest on others

It is not necessary to work out the actual filed cost for this purpose.

The age-wise classification of raw materials and finished goods is to be given. For this purpose age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately;

- (i) Inventory for more than one year;
- (ii) Between 6 months and one year;
- (iii) Between three months and 6 months; and
- (iv) Below 3 months.

Similar information about the work-in-progress i.e. the number of days of production which remains in progress should also be given.

The basis of valuation of raw material and finished goods should be given. For this purpose the following information is to be given:

- (i) The manner of determination of cost (i.e. components of cost)
- (ii) The method of valuing stock i.e. FIFO, weighted average cost, etc.

It is also necessary to state if there is any discrepancy between the quantity and value of the stock as furnished to the bank and as appearing in the books. The reasons for such discrepancy should be given in the audit report.

Age-wise classification of bills receivable and other receivables with reference to the, bills due from domestic parties and bills in respect of exports should be given. The age-wise classification is to be done on the same basis as the classification for raw materials and finished goods as stated above.

Information in respect of the following items is also to be given:

- (i) Balances at the end of each month of the quarter for major categories of stock, receivables and bills receivables;
- (ii) Tax assessments and payments made during the quarter;
- (iii) Actual disbursement of capital expenditure during the quarter;
- (iv) Outstanding contracts on capital account at the end of the quarter giving the details about the names of parties and amounts outstanding;
- (v) The contingent liability which may or may not materialize during the financial year succeeding the relevant quarter;
- (vi) Investment made during the quarter and the income from such investments including profit on sale of investments;
- (vii) Loans given during the quarter;
- (viii) Loans raised during the quarter from banks and from others. Separate figures to be given;

17.40 Advanced Auditing and Professional Ethics

- (ix) Overdue statutory liability at the end of the quarter;
- (x) Amounts due but not paid at the end of the quarter in respect of (a) loans from banks, (b) public deposits, and (c) other loans; and
- (xi) Figures of cash losses during the last 2 years to be stated on the basis of the annual accounts. If such accounts were not audited this fact should be stated.

The funds obtained from the lending banks have to be utilised for the purpose for which they are given by the bank. If the auditor finds that these funds have been diverted for the purposes other than those for which they were given by the bank the auditor will have to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give information about the following ratios:

- (a) Current ratio
- (b) Acid test ratio
- (c) Raw materials-turnover ratio
- (d) Finished goods-turnover ratio
- (e) Receivables-turnover ratio
- (f) Return on investment
- (g) Interest cover ratio
- (h) Net margin ratio
- (i) Capital turnover ratio
- (j) Debt equity ratio
- (k) Operating cash flow.

ANNEXURE

SEBI Checklist for Auditors

Books of Accounts & Other Records

Sl. No.	Description	Reference
1.	Maintenance of books of accounts	Rule 15 of SCR(R) Rules, 1957 and Regulation 17 of SEBI (Stock Broker and Sub-broker) Regulations, 1992
2.	Any other book / record to be maintained by the broker as per the exchange regulations	Rules, Regulations and Circulars of the concerned Exchange.

Contract Notes

1	The member should issue contract notes for all trades done by him	Regulation 7(B)(2) of Schedule II of Code of Conduct of SEBI (Stock Broker and Sub-brokers) Regulations, 1992
2	The member should time stamp his order slips/ records and the order time should be reflected in the contract note along with the time of execution of order.	Circular SMD/POICY/IECG/1-97 dated 11th February, 1997
3	The contract notes should bear the contract SEBI Registration number of the member. Contract notes should bear pre-printed serial numbers. Contract notes should be issued within 24 hours of trade execution. Appropriate stamps should be affixed on the original contract notes. Duplicates of the contract notes issued should be maintained. Counterfoils maintained should also have adequate details. The duplicates of the contract notes issued should be acknowledged by the client.	Rules and Regulations of the Exchange. Circular SMD/MDP/CIR/043/96 dated August 5, 1996.
4	The contract notes should be signed by the member or his constituted attorney	Rules and Regulations of the Exchange
5	In case of Form A contract notes issued to clients, the brokerage should be shown separately.	Ministry of Finance Directive - Circular F. No. 4/16/SE/19 dated 19th August, 1991

17.42 Advanced Auditing and Professional Ethics

6	In case the broker acts as a principal, the contracts issued should be in Form B	SMD(B)/104/22775/93 dated 29 th October, 1993
7	The consent of the client should be taken for any trade done by the broker while acting as a principal	Regulation 17 J of SEBI (Stock Broker and Sub-brokers) Regulations, 1992. Section 15 of SC(R) Act, 1956.
8	Brokerage should be within the limits prescribed by the Exchange	Rules and Regulations of the concerned Exchange.

Dealings with Clients

1	The member should maintain client database	Circular SMD/POLICY/IECG/1-97 dated 11th February, 1997
2	The member should make full payment / delivery within 24 hours of the relevant pay-out	Circular MIRSD/SE/Cir-19/2009 dated December 3, 2009
3	Warehousing of trades for Institutional Clients	Circular SMD/POLICY/CIR-29/97 dated 13th November, 1997
4	Rectification of bad delivery should be done within a reasonable time	Circular SMD/POLICY/4296/96 dated 4th October, 1996
5	In case of bad delivery because of fake shares, the introducing broker should file the necessary FIRs with the police.	Circular SMD/RCG/PJ/671/96 dated 22nd February, 1996
6	The member should not charge the clients with rates more than the prevailing market rates	Code of Conduct A & B under Regulation 7 of the SEBI (Brokers and Sub-brokers) Regulation, 1992
7	The member should take adequate steps for redressal of investors grievances within one month from date of receipt of the complaint	Rule 4(e) of SEBI (Stock Broker and Sub-brokers) Regulations, 1992
8	The member should maintain a separate bank account for clients' funds. There should be a clear segregation of the clients' and brokers' money. Payments to / from the client should be made from this separate account - there should be a clear segregation of business. The member should not make payments for trades in which he is a principal from the client's account. The member should keep such records and books of accounts as necessary, to distinguish client's securities from his own securities. The member should keep such records and books of accounts as	Circular SMD/SED/CIR/93/23321 dated 18th November, 1993.

	necessary, to distinguish client's securities from his own securities.	
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Funds and Resources

1	The member should not be involved in fund lending / borrowing activities except those in connection with or incidental to or consequential upon the securities business.	Regulations 8(1)(f) and 8(3)(f) of SC(R) Rules, 1957
2	The gross turnover of the member must be in direct correlation with the base capital / additional capital deposited by the member with the Exchange	Circulars SMD/SED/CIR/93/22570 dated 21st October, 1993 and SMD/SED/RCG/270/96 dated 19th January, 1996
3	The member should collect margin money from the clients in case of large orders / clients with frequent delays in payments deliveries / dispute of deals	Circular SMD/SED/CIR/93/23321 dated 18th November, 1993

Trading Operations

1	The member should be paying margin money as per the Exchange requirements on a regular basis. The auditor may also check the authenticity of the deals exempted from payment of margins, as in institutional deals, etc. Margins to be paid include Marked to Market margin, etc.	Circular SMD/RCG/2782/96 dated 16th July, 1996, Circular SMD/RCG/2995/96 dated 1st August, 1996, Circular SMD/POLICY/CIR-2/98 dated 14th January, 1998, Circular SMDRP/Policy/Circular-17/98 dated 2nd July, 1998, Circular SMDRP/POLICY/CIR-19/99 dated 2nd July, 1999 Circular SMDRP/POLICY/ CIR-26/99 dated 17th August, 1999
2	The member should report all off-market / negotiated deals to the concerned Exchange, within the time limits prescribed by the Exchange.	Circular SMD/RCG/(BKG)/293/95 dated 14th March, 1995
3	All off-market deals / negotiated deals entered into by the member should result in compulsory delivery.	Circular SMD/POLICY/Circular 3-97 dated 31st March, 1997 and Circular SMDRP/Policy/ Circular-20/98 dated 4th August, 1998
4	The member should not have entered into any fictitious transactions.	SEBI (Stock Broker and Sub-brokers) Regulations, 1992 - Code of Conduct

Regulatory Requirements

1	The member should have submitted the audit report for a financial year by 30th September of the next financial year	Circular SMD/SED/0072/92 dated 31st December, 1992
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17.44 Advanced Auditing and Professional Ethics

2	The member should not have any dealings with sub-brokers not registered with Securities and Exchange Board of India	Circular SMD/POLICY/CIRCULAR/3-97 dated 31st March, 1997
3	Members of Stock Exchanges acting as sub-brokers should register themselves with Securities and Exchange Board of India	Circular SMD/Policy/CIR-3/98 dated 16th January, 1998
4.	Annual payment of registration fees to SEBI, based on recommendations of the expert committee / court's order, if any	Circular SMD/SED/1430/93 dated 7th January, 1993, Circular SMD/ED/2132/96 dated 4th June, 1996, Circular SMD/Policy/CIR-4/98 dated 16th January, 1998, Circular SMD/DBA-II/CIR-31/98 dated 5th November, 1998
4	The auditor should look into the agreement entered into by the member and sub-broker, including adherence to the terms mentioned in the contract	Circular SMD/OPG/AA/1020/96 dated 14th March, 1996
5	The inspecting authority should check if the member has submitted information about himself, sought by SEBI	Circular SMD/Policy/Cir-7/98 dated 16th February, 1998.

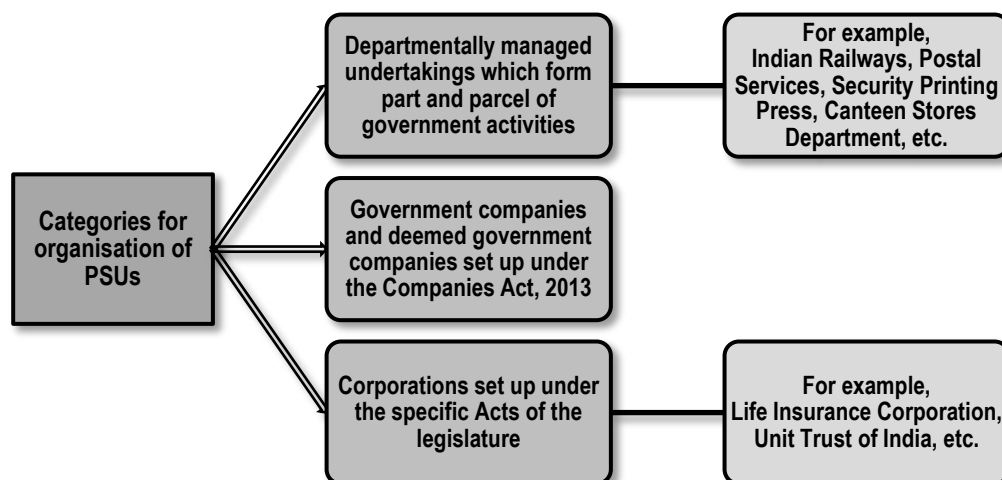
Audit of Public Sector Undertakings

18.1 Introduction

Public sector undertakings in India are fundamentally owned or controlled by central government, or any state government or governments, or partly by the central government and one or more state governments. The public enterprises have been assigned a key role in the socio-economic development of the country. These enterprises are industries supplying basic inputs to industry and agriculture, such as coal, oil, steel, minerals and metals, cement, chemicals and fertilizers and heavy equipment. Public utilities like the railways, postal and telecom services, electricity generation and supply, road transport, etc. constitute another class of public enterprises. Thus in India the public sector has achieved a dominant role in the national economy.



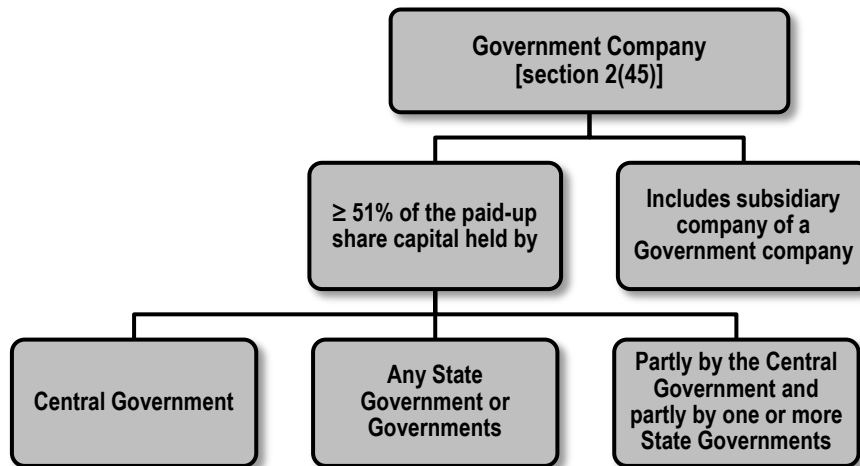
Fig.: Audit of PSUs*



* Source Times of India

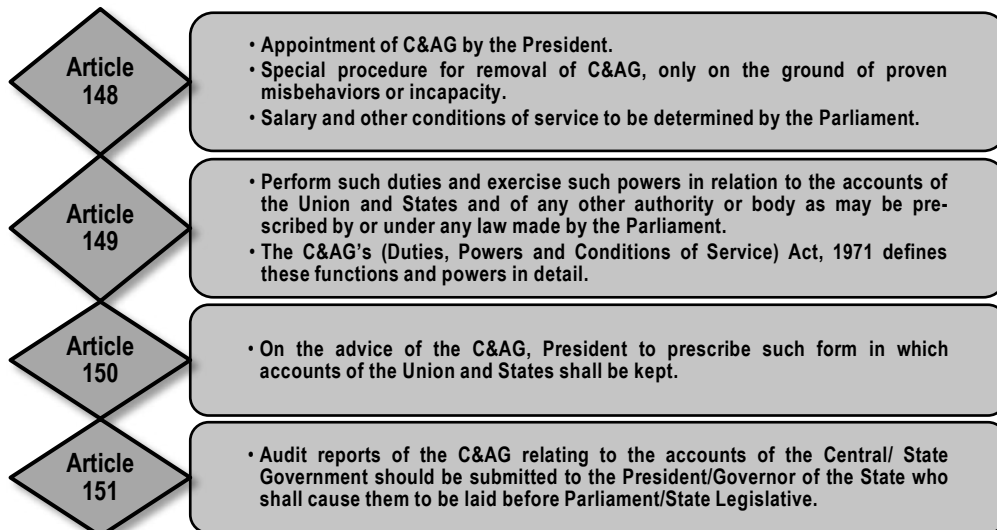
18.2 Framework for Government Audit

As defined under section 2(45) of the Companies Act, 2013, a “Government company” is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.



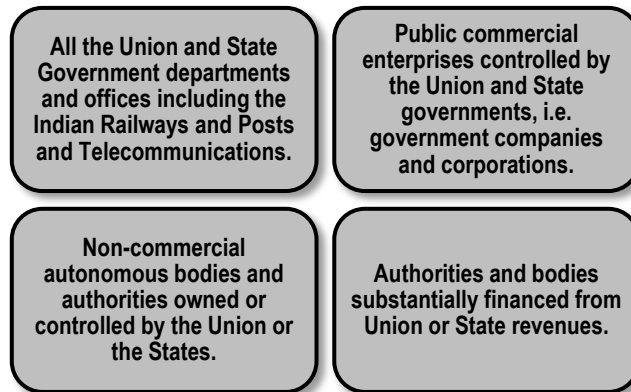
In India, government audit is performed by an independent constitutional authority, i.e. Comptroller and Audit General (C&AG) of India, through the Indian Audit and Accounts Department. The Constitution of India gives a special status to the C&AG and contains provisions to safeguard his independence.

Article 148 to 151 of the Constitution prescribes the role of C&AG of India as follows:



The Comptroller and Audit General's (Duties, Power and Conditions of Services) Act, 1971, prescribes that the C&AG shall hold office for a term of six years or upto the age of 65 years, whichever is earlier. He can resign at any time through a resignation letter addressed to the President. The Act also assigns the duties regarding the audit to be followed by C&AG.

The number of organisations subject to the audit of the Comptroller and Auditor General of India is very large. This includes:



As a result, the Comptroller and Auditor General of India has been issuing a large number of audit reports every year.

Audit of Government Companies (Commercial Audit) – There is a special arrangement for the audit of companies where the equity participation by Government is 51 percent or more. The auditors of these companies are Chartered Accountants, appointed by the Comptroller & Auditor General, who gives the auditors directions on the manner in which the audit should be conducted by them. He is also empowered to comment upon the audit reports of the auditors. In addition, he has a right to conduct a supplementary audit of such companies and cause test audit if considered necessary, by an order.

[Note: Audit of Government companies is discussed separately under Para 18.4]

Audit Board Setup in Commercial Audit – A unique feature of the audit conducted by the Indian Audit and Accounts Department is the constitution of Audit Boards for conducting comprehensive audit appraisals of the working of Public Sector Enterprises engaged in diverse sectors of the economy.

These Audit Boards associate with them experts in disciplines relevant to the appraisals. They discuss their findings and conclusions with the managements of the enterprises and their controlling ministries and departments of government to ascertain their view points before finalisation.

The results of such comprehensive appraisals are incorporated by the Comptroller and Auditor General in his reports.

It has no separate legal entity and works under the supervision and control of the Comptroller and Auditor General.

18.4 Advanced Auditing and Professional Ethics

Action on Audit Reports – The scrutiny of the Annual Accounts and the Audit Reports thereon by the Parliament as a whole would be an arduous task, considering their diverse and specialised nature, besides imposing excessive demands on the limited time available to the Parliament for discussion of issues of national importance. Therefore, the Parliament and the State Legislatures have, for this purpose, constituted specialized Committees like the Public Accounts Committee (PAC) and the Committee on Public Undertakings (COPU), to which these audit Reports and Annual Accounts automatically stand referred.

Public Accounts Committee (PAC) – It is the duty of the Public Accounts Committee to satisfy itself:

- (i) that the moneys were disbursed legally on the service or purpose to which they were applied.
- (ii) that the expenditure was authorised.
- (iii) that re-appropriation has been made in accordance with the provisions made (i.e. distribution of funds).

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor General either under the directions of the President or by a Statute of Parliament.

Estimates Committee – The Committee examines the estimates with a view to:

- (i) report that economies, improvements in organization, efficiency, consistent with the policy underlying the estimates may be effected;
- (ii) suggest alternative policies;
- (iii) examine whether the money is well laid out within the limit; and
- (iv) suggest the form in which the estimates shall be presented to Parliament.

The Committee does not comment upon a policy approved by Parliament, but where there is evidence that a particular policy is not leading to the desired results, or is leading to waste, it is the duty of the Committee to bring it to the notice of the House.

Committee on Public Undertakings – The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the Public Accounts Committee exercises over the functioning of the Government Departments. The functions of the Committee are -

- (i) to examine the reports and accounts of public undertakings.
- (ii) to examine the reports of the Comptroller & Auditor General on public undertakings.
- (iii) to examine the autonomy and efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.
- (iv) to exercise such other functions vested in the PAC and the Committee on Estimates as are not covered above and as may be allotted by the Speaker from time to time.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

The objective of the Financial Committees, in doing so, is not to focus only on the individual irregularity, but on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

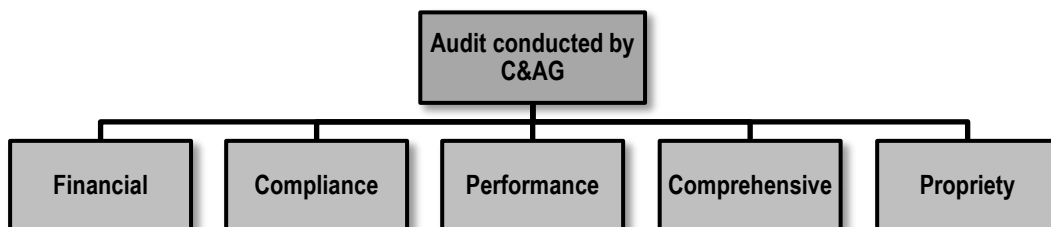
C&AG's Role – The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognised as a 'friend, philosopher and guide' of the Committees. His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports. He scrutinises the notes which the Ministries submit to the Committees and helps the Committees to check the correctness of submissions to the Committees and facts and figures in their draft reports.

The Financial Committees present their Report to the Parliament/ State Legislature with their observations and recommendations. The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature.

In respect of those cases in Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature. This ensures that the audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

18.3 Objective and Scope of Public Enterprises Audit

The C&AG's (Duties, Power and Conditions of Services) Act, 1971 specifies the entities that come under audit purview of C&AG at the Union and State level, however, the scope and extent of audit is determined by the C&AG itself.



(1) **Audit of PSUs not constrained to Financial and Compliance Audit:** Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to performance (efficiency, economy and effectiveness) with which these operate and fulfill their objectives and goals.

18.6 Advanced Auditing and Professional Ethics

(2) **Propriety Audit:** Another aspect of audit relates to questions of propriety. This audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety.

(3) **Comprehensive Audit:** Under comprehensive audit, the C&AG do not really cover again the field which has already been covered. He conducts an appraisal or an efficiency-cum-performance audit. He sees whether the undertakings have fulfilled the objectives for which they have been established, whether value-for-money spent has been obtained, whether the targets have been achieved, etc. He locates the areas of weakness including review of the decisions taken by the management and a comprehensive appraisal of the performance of the undertaking.

(4) **Organisation's Decision to be taken by Competent Authority:** In examining the decisions of a management, the auditor examines that these were taken by the competent authority after examination of all aspects (economic, technological, public interest) on the basis of all the relevant information available at that time and taking into consideration the different alternatives available to management and that the decisions were consistent with the aims and objectives of the enterprise.

(5) **Helping Government:** Audit is an instrument of accountability. But an equally important purpose of audit of public enterprises in India is to help the Government and the enterprise managements improve their efficiency and effectiveness. This is achieved by bringing out financial and operational deficiencies, inadequacies or ineffectiveness of systems, shortfalls in performance, etc. and by analysing the causes of shortfall from acceptable standards of performance.

(6) **Highlighting Issues of Efficient and Economic Operations:** Financial performance is linked with physical performance and issues of efficient and economic operations and management of resources are highlighted. There is an increasing emphasis on audit being an instrument of improvement.

(7) **Fiscal and Managerial Accountability:** In the broader context, Government audit encompasses two main elements, viz., (a) Fiscal Accountability: It includes audit of provisions of funds, sanctions, compliances and propriety; and (b) Managerial Accountability: It includes audit of efficiency, economy and effectiveness (This is often referred to as efficiency-cum-performance audit).

18.4 Audit of Government Companies

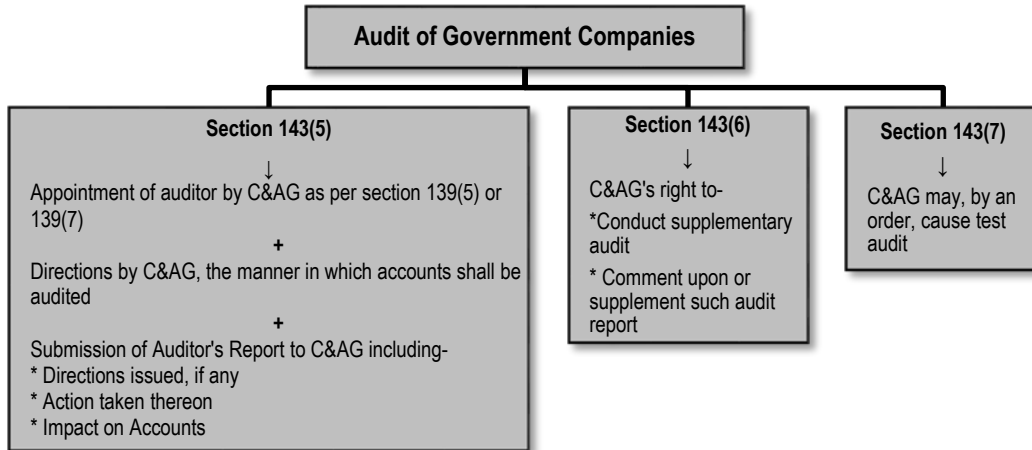


Diagram showing provisions of the Companies Act, 2013 related to Government Audit

The following steps are involved in the audit of government companies:

(a) Appointment of Auditors under Section 139(5) and 139(7) read with section 143(5) of the Companies Act, 2013 - Statutory auditors of Government Company are appointed or re-appointed by the Comptroller and Auditor General of India. There is thus a departure from the practice in vogue in the case of private sector companies where appointment or re-appointment of the auditors and their remuneration are decided by the members at the annual general meetings.

The C&AG may direct the appointed auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(b) Supplementary audit under section 143(6)(a) of the Companies Act, 2013 - The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct.

(c) Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013 - Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 of the said Act

18.8 Advanced Auditing and Professional Ethics

i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(d) Test audit under section 143(7) of the Companies Act, 2013 - Without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139 of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

18.5 Financial Audit

Financial audit is primarily conducted to express an audit opinion on a set of financial statements. It includes:

- (i) examination and evaluation of financial records and expression of opinion on Financial Statements;
- (ii) audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations which affect the accuracy and completeness of accounting records; and
- (iii) audit of internal control and internal audit functions that assist in safeguarding assets and resources and assure the accuracy and completeness of accounting records.

18.6 Compliance Audit

Compliance audit is an independent verification process of evaluating audit evidence to determine whether specified compliance requirements are met.

It examines the transactions relating to expenditure, receipts, assets and liabilities of Government for compliance with:

- (i) the provisions of the Constitution of India and the applicable laws; and
- (ii) the rules, regulations, orders and instructions issued by the competent authority either in pursuance of the provisions of the Constitution of India and the laws or by virtue of the powers formally delegated to it by a superior authority.

Compliance audit also includes an examination of the rules, regulations, orders and instructions for their legality, adequacy, transparency, propriety, prudence and effectiveness, that is, whether these are:

- (i) intra vires of the provisions of the Constitution of India and the laws (Legality);

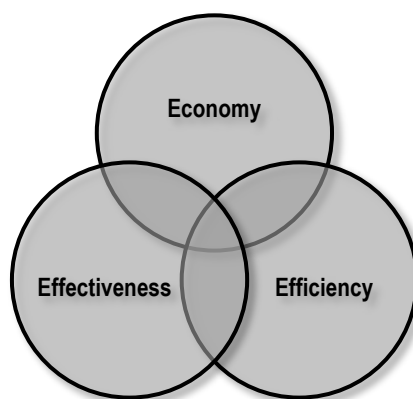
- (ii) sufficiently comprehensive and ensure effective control over Government receipts, expenditure, assets and liabilities with sufficient safeguards against loss due to wastage, misuse, mismanagement, errors, frauds and other irregularities (Adequacy);
- (iii) clear and free from ambiguity and promote observance of probity in decision making (Transparency);
- (iv) effective and achieve the intended objectives and aims (Effectiveness).

18.7 Performance Audit

A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audit in PSUs is conducted by the Comptroller and Auditor General of India (Supreme Audit Institutions) through various subordinate offices of Indian Audit and Accounts Department (IAAD). In conducting performance audit, the subordinate offices are guided by manual and auditing standards prescribed by CAG.

According to the guidelines issued by the C&AG of India, Performance Audits usually address the issues of:



- (i) **Economy-** It is minimising the cost of resources used for an activity, having regard to appropriate quantity, quality and at the best price.

Judging economy implies forming an opinion on the resources (e.g. human, financial and material) deployed. This requires assessing whether the given resources have been used economically and acquired in due time, in appropriate quantity and quality at the best price.

18.10 Advanced Auditing and Professional Ethics

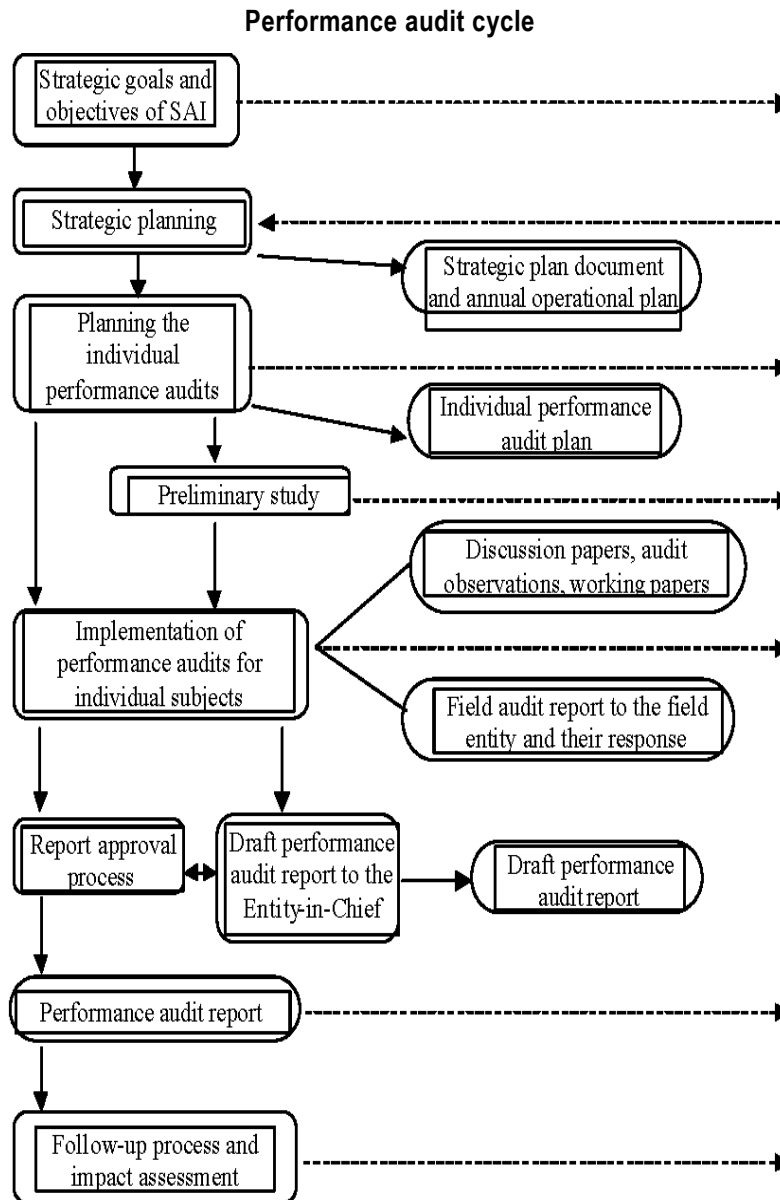
- (ii) **Efficiency-** It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximised at the minimum of inputs, or input is minimised for any given quantity and quality of output.

Auditing efficiency embraces aspects such as whether:

- (a) sound procurement practices are followed;
 - (b) resources are properly protected and maintained;
 - (c) human, financial and other resources are efficiently used;
 - (d) optimum amount of resources (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;
 - (e) public sector programmes, entities and activities are efficiently managed, regulated, organised and executed;
 - (f) efficient operating procedures are used; and
 - (g) the objectives of public sector programmes are met cost-effectively.
- (iii) **Effectiveness-** It is the extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.

In auditing effectiveness, performance audit may, for instance:

- (a) assess whether the objectives of and the means provided (legal, financial, etc.) for a new or ongoing public sector programme are proper, consistent, suitable or relevant to the policy;
- (b) determine the extent to which a program achieves a desired level of program results;
- (c) assess and establish with evidence whether the observed direct or indirect social and economic impacts of a policy are due to the policy or to other causes;
- (d) identify factors inhibiting satisfactory performance or goal-fulfilment;
- (e) assess whether the programme complements, duplicates, overlaps or counteracts other related programmes;
- (f) assess the effectiveness of the program and/or of individual program components;
- (g) determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
- (h) assess the adequacy of the management control system for measuring, monitoring and reporting a programme's effectiveness;
- (i) assess compliance with laws and regulations applicable to the program; and
- (j) identify ways of making programmes work more effectively.



18.7.1 Provisions contained in Companies Act, 2013 and C&AG's (Duties, Powers, and Conditions of Service) Act, 1971

According to section 19(1) of the Comptroller and Auditor General (Duties, Powers, and Conditions of Service) Act, 1971, the duties and powers of the Comptroller and Auditor General in relation to the audit of the Accounts of Government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act.

18.12 Advanced Auditing and Professional Ethics

Sub-section (6) and (7) of section 143 of the Companies Act, empowers Comptroller and Auditor General of India to conduct supplementary audit or test audit of Government companies. The CAG shall have right to conduct supplementary or test audit of the Government company's accounts by such person or persons as he may authorize in this behalf; and for the purposes of such audit to require information or additional information to such person or persons and in such form as the Comptroller and/ Auditor General may, by general or special order, direct.

The supplementary or test audit conducted by the Comptroller and Auditor General is in the nature of efficiency-cum-performance appraisal.

Section 143(5) of Companies Act requires the statutory auditor (chartered accountant appointed by CAG under section 139(5) or 139(7) of the Act) to submit a copy of his audit report on the accounts of the Government company to C&AG.

Thus section 143(6) and 143(7) of the Companies Act empowers C&AG to conduct supplementary audit and test audit respectively of annual accounts of a Government company.

In so far as statutory corporations are concerned the respective Statutes provide for audit by CAG. The scope includes conducting performance audit of these corporations also though specifically not stated so.

18.7.2 Objectives of Performance Auditing

The objectives of performance auditing are evaluation of economy, efficiency, and effectiveness of policy, programmes, organization and management. It also promotes accountability by assisting those charged with governance and oversight responsibilities to improve performance; and transparency by affording taxpayers, those targeted by government policies and other stakeholders an insight into the management and outcomes of different government activities.

Performance auditing focuses on areas in which it can add value which have the greatest potential for development. It provides constructive incentives for the responsible parties to take appropriate action.

Example

Performance Audit of enforcement mechanism for administering the provision of Minimum Wages Act (a social welfare legislation)

The auditors, who undertake performance audit of a program or unit, must possess knowledge of the industries or labor contracts where these provisions are applicable and also identify the population thereof before carrying out audit program. He shall evaluate the standard of living before implementation and after implementation of the Act.

Further, he shall have to evaluate the evidence available as to nature of returns prescribed and obtained for taking appropriate action.

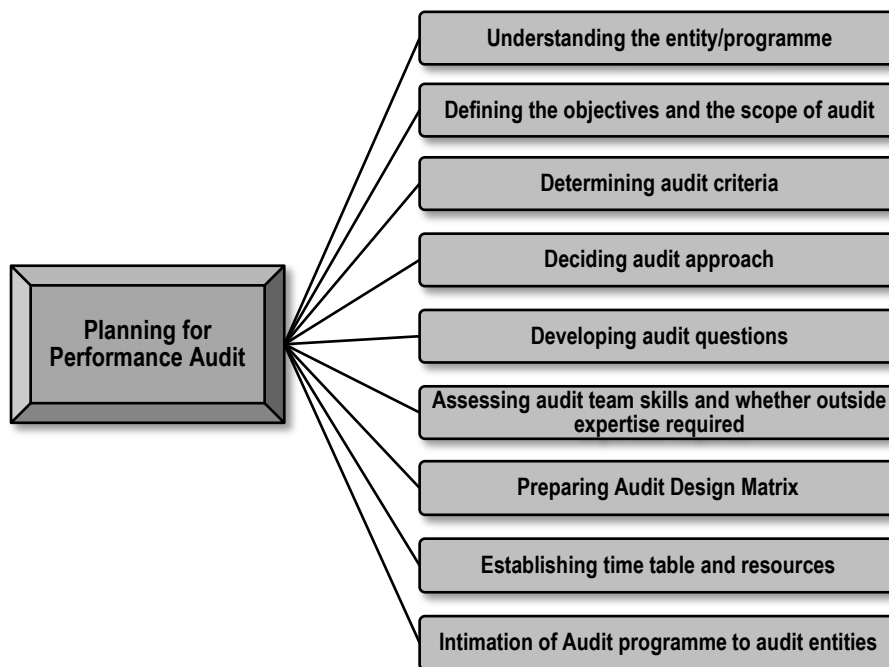
The Performance Auditor shall also have to evaluate the economy, efficiency and effectiveness in the welfare systems to be audited. He can then study the shortcomings in the coordination between different agencies like labor department, EPF and ESI organization and the control systems and point out a set of relevant problems.

Auditor shall also point out lacuna, if any in the existing legal frame work or enforcement mechanism to strengthen the objective of legislation. Another possible area of critical audit may be to study actual level of compensation required in each area keeping in mind the local living conditions and where the minimum wages prescribed in the statute is demonstrably different from this level he may report the same to the Government for taking appropriate action.

In this manner, the performance audit can not only examine the reasons for such vagaries but also ensures that the legislation serves the intended purpose. By reporting the same to the legislature, the corrective is made possible.

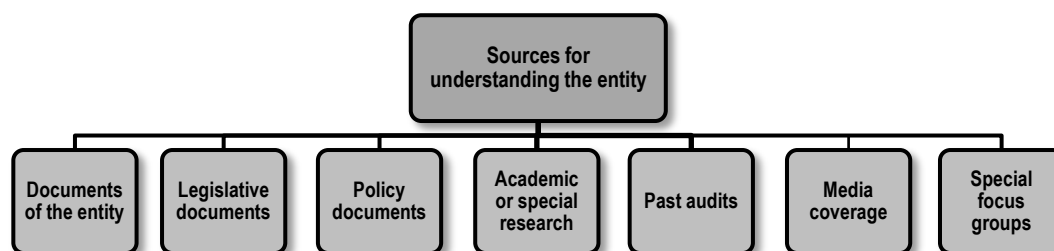
[Note: Interested students may refer to CPE Background Material on Performance Audit of Public Sector Enterprises in India published by the ICAI for further reference].

18.7.3 Planning for Performance Audit



The following steps are suggested to the auditors for planning while conducting the performance audit:

(A) Understanding the entity/programme - It is the starting point for planning individual performance audit.



The auditor may use the following sources for understanding the entity:

- (i) **Documents of the entity:** Documents on administration and functions of the entity, policy files, annual reports, budget documents, accounts, minutes of meetings, information on the website, internal audit reports, electronic databases and MIS reports, RTI material etc.
- (ii) **Legislative documents:** Legislation, parliamentary questions and debates, reports of the Public Accounts Committee, the Committee on Public Undertakings, the Estimates Committee and letters from Members of Parliament.
- (iii) **Policy documents:** Documents of Planning Commission, Ministry of Finance etc.
- (iv) **Academic or special research:** Independent evaluations on the entity, academic research and similar work done by other governments and other SAIs.
- (v) **Past audits:** Past financial and performance audits of the entity provide a major source of information and understanding.
- (vi) **Media coverage:** Print and electronic media - their systematic documentation on regular basis in a transparent manner.
- (vii) **Special focus groups:** Audit Advisory Committee concerns, annual and special reports of World Bank, Reserve Bank of India, reports by special interest groups, NGOs, etc.

(B) Defining the objectives and the scope of audit - The audit objectives should be defined in a succinct manner as they will impact the nature of the audit, govern its conduct and affect audit conclusions. Setting audit objectives ensures good quality performance audits. It facilitates clarity, demonstrates consistent quality of audit and serves as a measure of quality assurance of the audit.

Defining the scope constrict the audit to significant issues that relate to the audit objectives. It mainly focuses the extent, timing and nature of the audit.

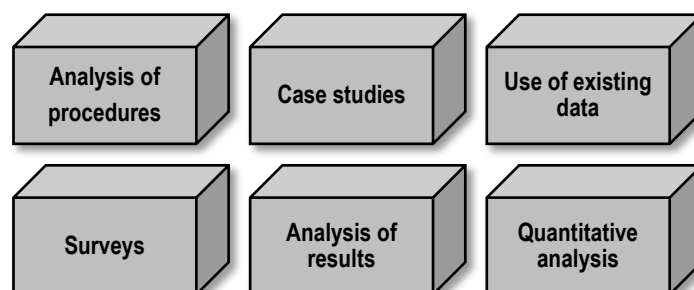
(C) Determining audit criteria - Audit criteria are the standards used to determine whether a program meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed.

The audit criteria may be sought to be obtained from the following sources:

- (i) procedure manuals of the entity.
- (ii) policies, standards, directives and guidelines.
- (iii) criteria used by the same entity or other entities in similar activities or programmes.
- (iv) independent expert opinion and know how.
- (v) new or established scientific knowledge and other reliable information.
- (vi) general management and subject matter literature and research papers.

(D) Deciding audit approach - There is no uniform audit approach prescribed that can be applicable to all types of subjects of performance audits. Selection of approach also determine methods and means used for conducting the audit.

Some of the methods which could be used in conducting performance audits include:



- (i) **Analysis of procedures:** It involves review of the systems in place for planning, conducting, checking and monitoring the activity. This would consist of examination of documents such as financial reports, budgets, programme guidelines, procedure manuals, etc.
- (ii) **Case studies:** A case study is a descriptive analysis of an entity, scheme or a programme. It involves analysis of a particular issue within the context of the whole area under review.
- (iii) **Use of existing data:** The audit staff should investigate the data held by entity management and by other relevant sources. Audit conclusions based on testing of available data for correctness and completeness enhances the assurance level.
- (iv) **Surveys:** Survey is a method of collecting information from members of a population to assess the interrelation of events and conditions. Surveys on predetermined parameters can supplement the audit findings and conclusions adding value to the performance audits.
- (v) **Analysis of results:** It requires the auditor to carry out actual output-input analysis to determine the efficiency of the programme.

18.16 Advanced Auditing and Professional Ethics

(vi) **Quantitative analysis:** It involves examination of available data relating to financials like earnings, revenue, or data relating to programme implementation like details of beneficiaries etc. However, it may not be possible for the auditor to work with complete data due to its high volume. In such cases, sampling techniques are required to be used.

(E) **Developing audit questions** - Subsequent to designing of audit objectives and determination of audit criteria, the audit team is required to prepare a list of questions to which they would seek answers. The questions should be framed in comprehensive manner involving detailed hierarchy of questions.

(F) **Assessing audit team skills and whether outside expertise required** - It is essential that the performance auditors possess special aptitude and knowledge. The Auditing Standards of C&AG of India provide that the audit institution should develop and train the auditors to enable them to perform their tasks effectively & efficiently and should prepare manuals & other written guidance notes & instructions concerning conduct of audits.

Given the diverse range of subjects of performance auditing, the audit team needs to develop sound understanding of the programme or entity proposed to be audited.

The audit team needs to decide at the planning stage on which aspect expertise is required. Though, the Accountant General may use the work of an expert, he retains full responsibility for the expression of opinion in the auditor's report.

(G) **Preparing Audit Design Matrix (ADM)** - Having determined the audit objective, audit criteria, audit approach, data collection etc., audit team should prepare an Audit Design Matrix. It is a structured and highly focused approach to designing a performance audit study.

It highlights the data collection and analysis method as well as the type and sources of evidence required to support audit opinion/findings.

The specimen of ADM is given as under:

Audit Objective (1)	Audit Questions (2)	Audit Criteria (3)	Evidence (4)	Data Collection and Analysis Method (5)

An ADM is prepared on the basis of information and knowledge obtained during the planning stage. A well-designed ADM leads to effective audits thus providing highest assurances to the auditing entities. It is desirable to prepare ADM for each of the audit objectives.

(H) **Establishing time table and resources** - It is significant to determine the timetable and desirable resources. Selection of appropriate audit team is the most vital component in planning an audit. Considerations for selection of an appropriate audit team should be recorded along with the proposed timelines for various activities to be undertaken as a part of audit process. The progress should also be monitored against these timelines. The Accountant General would be liable for ensuring that the performance audit is completed on time. The variations between the required and actual time spent should be compared and approved from the competent authority.

The team should build time for translation, approval and possible delays in their own schedule in order to meet the targets.

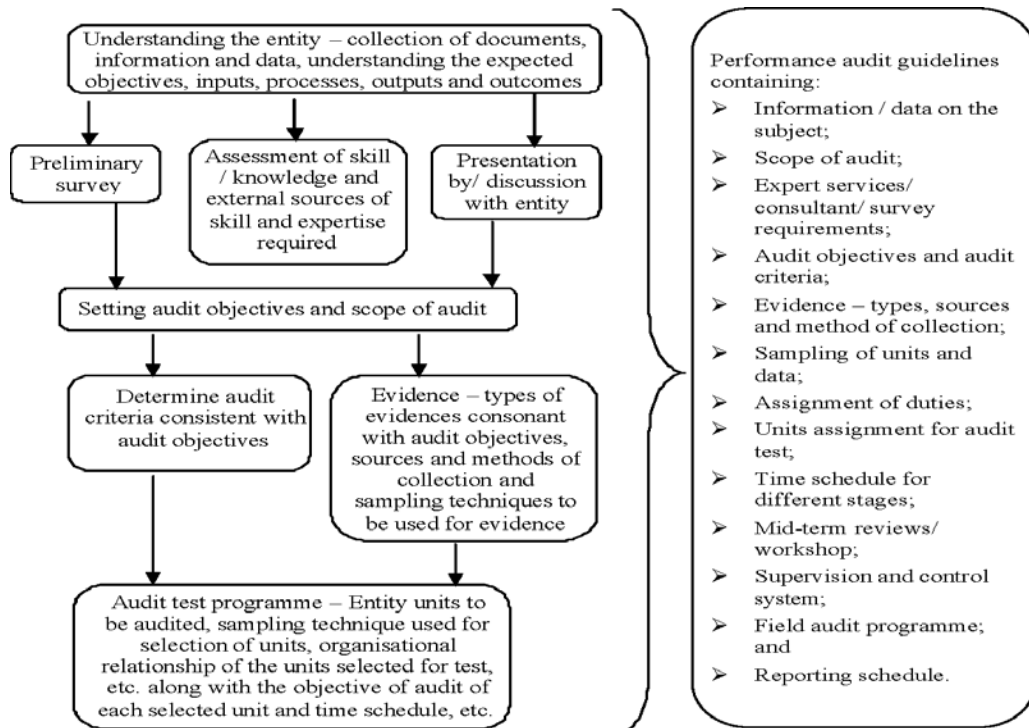
(I) Intimation of Audit programme to audit entities - Audited entities must be intimated about the intention of taking up planned performance audit with the scope and extent of audit including the constitution of audit team and the tentative time schedule, well before the commencement of Audit. Acknowledgement of this may be requested and placed on record.

It may be required to refine an audit's objectives as the audit progresses for gathering the requisite information to fulfill the audit. The reasons for such changes in the objectives should also be recorded and approved from the competent authority.

The audit programme should be flexible and reviewed from time to time as it is not possible to anticipate all the contingencies at the early stage.

The Accountant General should share all significant refinements in the approach and additional tests and findings, concurrently with other audit teams when different persons conduct the audit at different locations. The system of sharing of the significant field audit experience should be documented and reviewed.

Performance audit planning



18.8 Comprehensive Audit

The Comptroller and Auditor General assist the legislature in reviewing the performance of public undertakings. He conducts an efficiency-cum-performance audit other than the field which has already been covered either by the internal audit of the individual concerns or by

18.18 Advanced Auditing and Professional Ethics

the professional auditors. He locates the area of weakness and extravagance for managements' information.

The areas covered in comprehensive audit naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. However, in general, the covered areas are those of investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc.

Some of the issues examined in comprehensive audit are:

- (a) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?
- (b) Have the accepted production or operational outputs been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?
- (c) Has the planned rate of return been achieved?
- (d) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?
- (e) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?
- (f) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?
- (g) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?
- (h) If the enterprise has an adequate system of repairs and maintenance?
- (i) Are procedures effective and economical?
- (j) Is there any poor or insufficient or inefficient project planning?

The efficiency and effectiveness audit of public enterprises is conducted on the basis of certain standards and criteria. Profit is not the key criterion on performance; management's performance in the economical and efficient use of public funds and in the achievement of objectives is more relevant. Public enterprises have been set up with certain socio-economic purposes and for fulfillment of certain objectives. The objectives vary from enterprise to enterprise. Audit appraisal analyses the performance of an enterprise to bring out the extent to which the objectives for which the enterprise was set up have been served.

The feasibility/detailed project reports give the basis of investment, capacity, costs, time schedules, gestation period, etc. and are built up of capacities, parameters and norms of consumption, yields, productivity, costs, rate of return, etc. These provide yardsticks by which the performance is measured. Some of the parameters may change due to external or internal factors subsequent to the setting up of the enterprise/project.

In conducting efficiency audit due account is taken of the changes effected. Then enterprises are required to have their long and short term capital and operational plans and these provide another set of reference points for assessment of performance. Rated capacity of the unit provides an acceptable benchmark against which physical performance is evaluated. However, utilisation of the rated capacity is assessed along with norms for consumption of raw materials and utilities, yields and rejections as well as requirements for proper maintenance and servicing of equipment. Cost efficiency is another important basis in appraising performance. Standard or target costs are determined on the basis of norms of capacity utilisation, consumption, productivity, yield etc. given in the detailed project reports, moderated in many cases by expert studies to take care of later constraints and changes.

The Bureau of Public Enterprises has issued guidelines to be followed by the public sector enterprises in respect of general management, financial management, materials management, production management, construction management, etc. and these guidelines provide another basis for appraising enterprise performance and its systems. Another source of criteria is industrial engineering and other technical studies by internal and external experts and the standards given in these. Then there are standards of financial propriety.

The starting point of a comprehensive appraisal of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the instructions to the audit parties assigned to the work.

18.9 Propriety Audit

Auditing, as a composite concept, looks into accounting and arithmetical accuracy, adherence to rules and regulations, propriety and the end result. According to the varied requirements, the emphasis on each of the aforesaid factors differs between various types of audit. Students should carefully go through section 143 of the Companies Act, 2013. All the requirements of this section are applicable to a Government Company and the analysis that will follow will show that some of the provisions of section 143 really are propriety based. ***Besides, the Companies (Auditor's Report) Order, 2016 issued under section 143(11) of the Companies Act, is also applicable to a Government Company, provided the Government Company belongs to any of the categories of companies to which the Order applies.***

18.20 Advanced Auditing and Professional Ethics

Finally, the Comptroller and Auditor General has issued a set of detailed directions under Companies Act which are to be complied with by the independent professional auditor in carrying out the audit of Government Companies. Propriety already exists in the audits carried on by the Comptroller and Auditor General of India.

18.9.1 Definition and Principles

Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct.

E.L. Kohler has defined the term propriety as “that which meets the tests of public interest, commonly accepted customs, and standards of conduct, and particularly as applied to professional performance, requirements of law, Government regulations and professional codes”. On an analysis, the tests boil down to tests on economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure.

Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances.

In ‘propriety audit’, the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. For example, a building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in infructuous expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.

Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit. It is hard to frame any precise rules for regulating the course of audit against propriety. Such an objective of audit depends for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit. However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety.

Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

- (i) that the expenditure is not *prima facie* more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;
- (ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage;
- (iii) that funds are not utilised for the benefit of a particular person or group of persons and
- (iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and infructuous expenditure.

18.9.2 Relevant provisions in the Companies Act, 2013

The Parliament and Government, with a view to knowing the standards of efficiency, propriety, cost consciousness and economy, have already come up with some provisions in the Companies Act, having direct or indirect bearing on propriety; some of these have been referred to earlier. These provisions are:

1. Section 148 relating to Cost Records and Audit.
2. Section 143(1) requiring enquiry into certain specified matters.
3. Section 143(6) and 143(7) requiring a supplementary audit and test audit respectively in respect of the Government companies on matters specified.
4. Additional information in Part II of Schedule III.

All these are applicable to Government Companies. The requirement of the provisions of section 143(1) is essentially propriety-oriented as much as some specific dubious practices are required to be looked into by the auditor. Areas of propriety audit under the provisions of Section 143(1) may be following:

- (a) Whether the terms on which secured loans and secured advances have been made are prejudicial to the interests of the company or its members.

It may be appreciated that the terms of loans include such matters as security, interest, repayment period and other business considerations. The auditor has to inquire whether the terms are such that they can be adjudged as prejudicial to the legitimate interest of the company or of its shareholders. This is a process of judging a situation by reference to certain objective standards or reasonableness whether the terms entered into are prejudicial or not, not only to the company but also to the shareholders.

- (b) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company. This proposition has got to be inquired into by

18.22 Advanced Auditing and Professional Ethics

reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards. It is also possible that some transactions may not adversely affect the interests of the company. The auditor has to judiciously consider what does and does not constitute the interest of the company.

- (c) Whether investment of companies, other than a banking or an investment company, in the form of shares, debentures and other securities have been sold at a price lower than the cost. Apparently, this is a matter of verification by the auditor. The intention, however, is not know whether loss has occurred due to the sale. The auditor is required to inquire into circumstances of sale of investments that resulted in loss. Obviously, the duty cast on him is propriety based, i.e., reasonableness of the decision to sell at a loss. It involves exercise of judgment having regard to the circumstances in which the company was placed at the time of making the sale.
- (d) Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made.
- (e) Whether personal expenses have been charged to revenue. It is an accepted principle that expenses which are not business expenses should not be charged to revenue. The effect of charging personal expenses to the business is to distort the profitability of the company and to secure a personal gain at the cost of the company. Obviously, propriety is involved in this; charging personal expenses to business account is highly improper and abusive hence this provision.
- (f) In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading. A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.

Cost records and the provisions of cost audit are designed to inculcate cost consciousness in the management and to know whether productivity is of acceptable order and whether undue wastage or loss etc. has occurred. It would be useful to go into some of the specific requirement of cost audit report in this context. Some of the matters in the additional information sought through the Statement of Profit and Loss (i.e., Part II of Schedule III) provide a basis for making more searching enquiries into such vital matters as consumption of raw materials under broad heads, goods purchased under broad heads, work in progress under broad heads, any item of income or expenditure which exceeds one percent of the revenue from operations or ₹ 1,00,000, whichever is higher, etc.

The implications of the Companies (Auditor's Report) Order, 2016 and the provisions of the section 143(6) and the directions issued by the Comptroller and Auditor General also contain significant elements of propriety.

18.9.3 Propriety elements under CARO, 2016:

(a) If the company has granted any loans, secured or unsecured, to companies, firms limited liabilities partnerships or other parties covered in the register maintained under section 189 of the Companies Act, whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest, whether the repayment of the principal amount and interest are stipulated and whether repayments or receipts are regular. For this, the auditor should take note of repayment schedule. If loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of receipt of interest, for example, letters of understanding, acknowledgement by the party of the terms and conditions communicated by the company, etc. The dates of receipt of principal amount and interest thereof needs to be verified with reference to the books of accounts of the company to come to the conclusion whether such receipts are regular.

(b) If the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest.. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, period of delay and other similar factors, issue of reminders or sending of advocate's or solicitor's notice may amount to reasonable steps. The auditor should ask the management to give in writing the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations.

(c) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.

(d) whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

(e) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated; by the auditor. In addition, where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the

forum where dispute is pending shall be mentioned by the auditor. It may be noted that mere representation to the concerned Department shall not be treated as a dispute.

(f) If the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided). The auditor should obtain a schedule of repayments to banks, financial institutions and debenture holders from the management of the company. He should examine the agreement or other documents containing the terms and conditions of the loans and borrowings of the company from banks and financial institutions. The auditor should also examine the debenture trust deed. This examination would enable the auditor in verifying the amount and due dates of the payments mentioned in schedule of repayments provided by the management of the company. The auditor should then verify whether the repayments as per the books of account are in accordance with the terms and conditions of the relevant agreement. The auditor should also satisfy himself that the repayment have actually been made to the party concerned.

(g) Whether the term loans were applied for the purpose for which the loans were obtained. The auditor should examine the terms and conditions subject to which the company has obtained the term loans. The auditor may also examine the proposal for grant of loan made to the bank. The auditor should compare the purpose for which term loans were sanctioned with the actual utilisation of the loans. He should obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised.

(h) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(i) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

For this, while planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should also discuss the matter with other employees of the company.

(j) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;

(k) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(l) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

(m) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;

From the above analysis, it is somewhat clear that under the Companies Act, we already have tools which bring about a blending of propriety to the professional audit of Government companies. However, a word of caution is necessary in this context. The audit conducted by the Comptroller and Auditor General is a rule, procedure and propriety-based one; and often it is said that the desired flexibility is lacking in the system and this has contributed in a large measure to the lack of rapport between the auditor and the audit-units. Honesty is open to question, if that honesty has deviated from laid down rules and procedures. In turn, this has tended to foster a tendency amongst Government officials to just conform to the rules and provide a show of compliance with the standards of propriety. This is not intended to be little the contribution of this audit in ensuring appropriate use of fund of the Government. In Government, because of the enormous amounts involved and the massive volume of transactions and in view of public interest, it is but necessary that compliance with rules should be insisted upon and non-compliance enquired into. But the benefit derived is at least partly offset by the element of distrust and often the truth remains buried.

One distinguishing feature should be observed; excepting the directions of the Comptroller and Auditor General under the Companies Act, the rest of the provisions are applicable equally to government and non-government companies. Whatever elements of propriety are discernible in them are also present in the audit of non-government companies. The directions generally known as Comptroller and Auditor General's directions, however, are exclusively applicable to the audit of Government companies.

Propriety Audit-Problems - Problems in propriety audit, however, arise mainly because of its distinct nature. The expression "propriety" is a moral term and can be understood by reference to the concept of morality accepted by the society at a given time. In any auditing, the essential test lies in formulation of auditing propositions. In the audit of financial accounts by reference to financial and legal requirements, propositions are built up about happening of events, existence, accuracy, title, ownership, compliance with law and internal regulations etc., which are all verifiable. In propriety audit the formulation of verifiable auditing propositions poses the problem.

18.26 Advanced Auditing and Professional Ethics

Propriety audit has an inherent element of subjectivity because it is very difficult to establish standards of public interest, commonly accepted customs, standards for conduct which are not firm basis for audit evaluation. To take care of this situation, the C&AG has developed the norms of propriety for expenditure of public funds in our country. By laying down the standards of propriety for Government expenditure the C&AG has really tried to tackle in a practical way the complex problem of subjectivity inherent in a situation calling for propriety consideration.

The norms so developed provide the basis of verifying expenditure incurred by various Government departments. It may be appreciated that the norms of propriety applicable to governmental transactions may not *ipso facto* apply to transactions of private sector which have distinct and more limited, objectives suited to them. Each private sector entity may have its unique objectives related, to its management philosophy and the transactions should be geared to achieve those. For example, a management which is operating for maximization of profits without infringing, any legal regulations may follow certain policies while another management believing in a wider measure of social justice may follow different policies. Despite these clear angularities, certain commonness can also be discerned in the policies and approaches of different managements. They include efficient operations, higher productivity and higher profit, reduction of wasteful expenditure etc. Above all, each entity has its impact on the society and building up propriety audit propositions becomes of paramount importance.

It is felt that if the management of each entity, irrespective of any legal requirements, formulates norms of propriety for the entity, taking full note of wider social repercussions inherent in its operations; a formidable hurdle in the way of wider introduction of propriety audit can be removed. The element of subjectivity in propriety evaluation will get reduced.

Propriety as a moral element should be a matter of evaluation based on objectives and prevailing circumstances. For example, a travel by air as such should not be considered wasteful unless it is proved that a travel by rail would have been feasible in the circumstances and would have brought the same results brought by the air travel.

The element of subjectivity has caused proper discharge of duty very delicate and demands discretion, but wisdom of taking commercial decisions under dynamic environment (the economic, social and political) must be evaluated with reference to the circumstances in which these were taken and therefore, the auditor in his field must reconstruct such circumstances. The judgment of the auditor must be objective as otherwise it would dampen the initiative of management and others in taking commercial decisions and propriety audit would prove itself to be counter productive.

18.10 Audit Report of the Comptroller and Auditor General

For facility of consideration, the reports of the Comptroller and Auditor General on the public sector undertakings of the Central Government are presented to the Parliament in several parts consisting of the following:

- (a) Introduction containing a general review of the working results of Government companies, deemed Government companies and corporations.

- (b) Results of comprehensive appraisals of selected undertakings conducted by the Audit Board.
- (c) Resume of the company auditors' reports submitted by them under the directions issued by the Comptroller and Auditor General and that of comments on the accounts of the Government companies.
- (d) Significant results of audit of the undertakings not taken up for appraisal by the Audit Board.

For certain specified states, the Comptroller and Auditor General submit a separate audit report (commercial) to the legislature, while for other States/Union Territories with legislature, there is a commercial chapter in the main audit report. The State audit reports, contains both the results of audit appraisal of performance of selected companies/corporations as well as important individual instances of financial irregularities, wasteful expenditure, system deficiencies noticed by the statutory auditors, comments noticed in Government audit in the audit functions of certification of accounts and a general review of the working results of Government companies and corporations.

***Specimen (abridged) Performance Report issued by
the Comptroller and Auditor General of India***

I. Performance Audit on functioning of Internal Audit in Income Tax Department for the year ended March, 2015

This Report for the year ended March 2015 has been prepared for submission to the President under Article 151 of the Constitution of India.

Income Tax Department (ITD) is subjected to Internal Audit of assessment and accounting functions. The audit objectives of the "Functioning of Internal Audit Wing in Income Tax Department" were to derive an assurance whether:

- (a) Internal audit is effective in providing reasonable assurance to the CBDT and Senior Management regarding achievement of objectives relating to compliance, assessment and other interrelated activities, as determined by CBDT.
- (b) Internal audit is playing an effective role in enhancing the quality of assessments.
- (c) There is an effective and efficient follow-up mechanism of internal audit findings and recommendations.

We examined the control issues relevant to CIT (Audit) charges and monitoring mechanism at the level of DIT (Audit) as well as Regional Supervisory Authorities administering the CIT (Audit) charges.

We found that Action Plan was not prepared in 17 CIT (Audit) charges. We noticed that list of auditable cases were not received on a regular basis in 19 CsIT (Audit) charges from administrative CsIT under Pr. CCsIT/CCsIT of 12 regions.

18.28 Advanced Auditing and Professional Ethics

We noticed that out of 7,00,398 cases assigned, Internal Audit examined only 5,73,457 cases resulting in shortfall in coverage of 1,26,941 cases. The practice of selection of high risk units is not in place.

We found that there were delays in initiation of remedial action in 6,172 cases (13 regions) and delays in completion of remedial action in 1,640 cases (10 regions). We noticed 73 cases involving tax effect of ₹ 134.10 crore in six regions where Internal Audit objections were settled without proper reply or completion of remedial action. Inadequate follow up of Internal Audit objections resulted in time barring of 1,553 cases involving tax effect of ₹ 392.65 crore in 11 CsIT (Audit) charges.

The audit has been conducted in conformity with the Auditing Standards issued by the Comptroller and Auditor General of India.

Audit wishes to acknowledge the cooperation received from the Department of Revenue - Central Board of Direct Taxes at each stage of the audit process.

II. Performance of 100% Export Oriented Unit (EOU) scheme of Department of Revenue-Indirect Taxes, Customs for the year ended March, 2014

This Report for the year ended March 2014 has been prepared for submission to the President of India under Article 151 of the Constitution of India.

A Performance Audit on the working of the EOU, corresponding to the Foreign Trade Policy (2009-14), was conducted with a view to seek an assurance that:

- (a) there exists adequate statutory provision/rules regulation, instructions/notification with regards to approval, creation, functioning and monitoring of EOUs.
- (b) the EOUs fulfilled the import conditions as laid down in the relevant notifications and FTP and applicable provisions of HBP.
- (c) the EOUs were able to fulfill the intended objectives as stated in the Foreign Trade Policy.
- (d) the internal controls system and monitoring mechanism are effective.

The total number of EOUs has gone down from 3109 in 2009-10 to 2608 in 2013-14. While the number of functional units has come down from 2279 to 2095 during the same period, the percentage of functional units to total units has declined from 83 per cent in 2010-11 to 80 per cent in 2013-14 with corresponding increase in percentage of non-functional and deboned units. There has been a gradual reduction in EOUs after the SEZ Act came into force in 2006-07.

Government of India had forgone significant customs revenue amounting to ₹ 32,932 crore during 2009-10 to 2013-14 on EOU/EHTP/STP schemes. Government has fallen short by almost 33 per cent (US\$ 150 billion) of its export target in 2013-14 vis-a-vis its Strategic Plan (DoC).

Audit wishes to acknowledge the cooperation received from Ministry of Commerce and Industry (DoC) and Department of Revenue (DoR) and its field formations at each stage of the audit process.

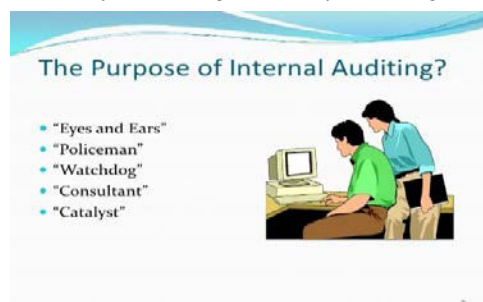
19

Internal Audit, Management and Operational Audit

19.1 Internal Audit

Many modern enterprises have become huge and sophisticated. This has resulted in decentralisation of their activities and consequently the top management is remotely concerned with the day-to-day activities of the concern. In this context internal auditing has acquired a great deal of significance.

Considering the increasing importance of internal auditing, the Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non-standing committee on February 5, 2004. The CIA was constituted with the object of formulating Standards and Guidance Notes on Internal Audit. As defined in scope of the standards on Internal Audit, Internal Audit means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.



The internal auditing need not be confined to financial transactions and its scope may be extended to the task of reviewing whether the resource utilisation of the enterprise is efficient and economical. This would necessitate a review of all operations of the enterprise as also an evaluation of the effectiveness of management. We should not however lose sight of the fact that internal auditing is basically a service activity.

Fig.: Internal Audit*

The internal auditor has to review and report; he is not expected to take upon himself functions of the operational managers.

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall

* Source: Slide Share

19.2 Advanced Auditing and Professional Ethics

be required to appoint **an internal auditor which may be either an individual or a partnership firm or a body corporate**, namely-

- (a) every listed company;
- (b) every unlisted public company having-
 - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
 - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) every private company having-
 - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

Who can be appointed as Internal Auditor? As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

To be effective, the internal auditor must be regarded as part of the management and not merely as an assistant thereto. He must have authority to investigate from the financial angles, every phase of the organisational activity under any circumstances. In recent years, there has been a growing tendency in Western countries to make the internal auditor responsible directly to the Board of Directors for the maintenance of adequate accounting procedures and for the preparation of financial statements and reports as regards the functioning of the business. His main responsibility, however, must be to maintain adequate system of internal control by a continuous examination of accounting procedures, receipts and disbursements and to provide adequate safeguards against misappropriation of assets. In carrying out these functions, he must operate independently of the accounting staff and must not in any way divest himself of any of the responsibilities placed upon him. He should also not involve himself in the performance of executive functions in order that his objective outlook does not get obscured by the creation of vested interest.

It may be further pointed out that internal auditors who are qualified accountants, because of

their training and experience, can be of great assistance to the management even in fields other than accounting. They can observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, they critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected. In order that an internal auditor may be able to play such a role in the field of management, he must be closely associated with it and his knowledge must be kept up to date by his being kept informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies. Also, he must enjoy an independent status.

In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

The Research Committee of the Institute of Chartered Accountants of India has brought out "General Guidelines on Internal auditing". The following discussion is based upon the above publication.

19.2 Management Functions and Scope of Internal Auditing

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints. To achieve optimum utilisation of resources management should determine the goals and objectives of the concern, quantify them to the extent possible, develop major policies and plans, implement them and exercise control over such implementation.

Each of the managerial functions should constantly be viewed by the internal auditor. Translated into more concrete terms, the scope of internal auditor's work should include a review of-

- (i) internal control system and procedures.
- (ii) system regarding the custodianship and safeguarding of assets - monetary and non-monetary of enterprise.
- (iii) compliance by the various segments with the policies, plans and procedures of the enterprise as well as with the relevant regulations and laws.
- (iv) system of collecting data both monetary and non-monetary - to ensure that the information given to management and to external agencies is relevant and reliable.
- (v) organisational structure of the enterprise and its congruence with its objectives.
- (vi) efficient and economical use of available resources tangible as well as intangible.
- (vii) various operations.

On the basis of such review, the internal auditor should in his report, highlight the weaknesses

19.4 Advanced Auditing and Professional Ethics

observed and give suggestions for improvement. We may now have a brief description on each of the above areas of review:

- (i) **Review of internal control system and procedures -**
 - (a) The internal auditor should determine whether the internal control system is in consonance with the organisational structure. As far as possible, controls should be in-built in the operating functions, if they are to be cost effective. For example, the establishment of a separate credit control department would not be justified if the objective of reducing credit risk and minimising debt recovery period could be met through controls in-built in the accounting and sales systems especially in smaller and medium sized concerns.
 - (b) Each control should be reviewed and analysed in terms of its costs and benefits. It should also be seen whether the internal controls were in use throughout the period of intended reliance. A break-down in internal controls for a specific portion of intended reliance would need special attention.
- (ii) **Review of custodianship and safeguarding of assets -** The internal auditor should review the control systems to ensure that all assets are accounted for fully. He should review the means used for safeguarding assets against losses e.g. fire, improper or negligent activity, theft and illegal acts etc. He should review the control systems for intangible assets e.g. the procedures relating to credit control. Where an enterprise uses electronic data processing equipment, the physical and systems control on processing facilities as well as on data storage should be examined and tested fire should review the adequacy of the insurance cover for the various risks involved. He should also verify the existence of the assets.
- (iii) **Review of compliance with policies, plans, procedures and regulations -** It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in coordinated manner. He should examine the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of the enterprise. By combining the results of his review of the adequacy of the systems with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former. He should point out specific weaknesses and suggest remedial action.
- (iv) **Review of relevance and reliability of information -** The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, trade organisations and labour unions. For the purpose the internal auditor should review the means used for measuring, classifying and reporting information including the records from which the information is extracted. He should examine the accuracy and reliability of financial and operational records. The usefulness of the reports as well as of the records should be evaluated with reference to their costs. The internal auditor should examine

whether the reporting is by exception i.e. the reports highlight the significant and distinctive features.

- (v) **Review of the organisation structure** - The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose he should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern. The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others. He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between authority and responsibility of important executives. This can be evaluated by discussing the problems of operations and implementation with various executives. The internal auditor should examine the reasonableness of the span of control of each executive (the number of sub-ordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior. Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned. Finally, he should evaluate the process of managerial development in the enterprise. This is a vital aspect in a fast growing enterprise.
- (vi) **Review of utilisation of resources** - The internal auditor should check whether proper operating standards and norms have been established for measuring economical and efficient use of resources. They should be detailed enough to be identifiable with specific operating responsibilities and should be capable of being used by operating personnel for monitoring and evaluating their performance. The internal auditor should review the methods of establishing the operating standards and norms. He should carefully examine the assumptions made while setting the standards to ensure that they are appropriate and necessary. The variances should be examined to evaluate whether or not the standards and norms are practical. Where there is a wide divergence between actual performance and the corresponding standards, reasons may be looked into. As a part of evaluating resources utilisation, identifying the facilities which are under-utilized is an important function of the internal auditor. Such instances may consist of under-utilized machines, unoccupied storage space, huge cash or bank balances, idle man power etc. While commenting on staffing, the internal auditor should pay special attention to non-productive work being performed. This would require an enquiry into the job descriptions of employees combined with an intelligent observation of the work being done.
- (vii) **Review of accomplishment of goals and objectives** - The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are attainable. The internal auditor should examine whether to the extent possible, objectives are expressed in precise quantifiable terms (both monetary and non-monetary) to facilitate detailed planning to be made for achieving them. Budgeting forms an important part of

19.6 Advanced Auditing and Professional Ethics

such planning. This will ensure that plans anticipate the problem areas. There should also be sufficient flexibility in the plans to permit such improvements in their implementation, as would benefit the enterprises as a whole.

19.3 Integrity, Objectivity and Independence of Internal Auditor

As per Standard on Internal Audit (SIA) 2, Basic Principles Governing Internal Audit, issued by the Council of the Institute of Chartered Accountants of India. The internal auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude. He should not only be independent in fact but also appear to be independent. The internal auditor should not, therefore, to the extent possible, undertake activities, which are or might appear to be incompatible with his independence and objectivity. For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference. For example, in case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer. The internal auditor should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.

19.4 Qualifications of Internal Auditor

The internal auditor should have the special expertise necessary for evaluating management control systems, especially financial and accounting controls. Accounting and finance functions provide basic data for management control of an enterprise. Therefore the internal auditor must have accounting and financial expertise to be able to discharge his duties.

The internal auditor is also expected to evaluate operational performance and non-monetary, operational controls. This requires a basic knowledge of the technology and commercial practices of the enterprise. He should also have a basic knowledge of commerce, laws, taxation, cost accounting, economics, quantitative methods and EDP systems. An understanding of management principles and techniques is another essential qualification of an internal auditor as also the ability to deal with people. By his conduct the internal auditor should provide an assurance to the management that confidentiality of such information would be maintained.

19.5 Internal Audit Report

As per Standard on Internal Audit (SIA) 2, Basic Principles Governing Internal Audit, issued by the Council of the Institute of Chartered Accountants of India, the internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of

assets, it would be more appropriate for him to bring the same immediately to the attention of the management.

Basic Elements of the Internal Audit Report: Basic elements of the internal audit report as per Standard on Internal Audit (SIA) 4, on Reporting issued by the Council of the Institute of Chartered Accountants of India. The internal auditor's report includes the following basic elements, ordinarily, in the following layout:

- (a) Title;
- (b) Addressee;
- (c) Report Distribution List;
- (d) Period of coverage of the Report;
- (e) Opening or introductory paragraph;
 - (i) identification of the processes/functions and items of financial statements audited; and
 - (ii) a statement of the responsibility of the entity's management and the responsibility of the internal auditor;
- (f) Objectives paragraph - statement of the objectives and scope of the internal audit engagement;
- (g) Scope paragraph (describing the nature of an internal audit):
 - (i) a reference to the generally accepted audit procedures in India, as applicable;
 - (ii) a description of the engagement background and the methodology of the internal audit together with procedures performed by the internal auditor; and
 - (iii) a description of the population and the sampling technique used.
- (h) Executive Summary, highlighting the key material issues, observations, control weaknesses and exceptions;
- (i) Observations, findings and recommendations made by the internal auditor;
- (j) Comments from the local management;
- (k) Action Taken Report – Action taken/ not taken pursuant to the observations made in the previous internal audit reports;
- (l) Date of the report;
- (m) Place of signature; and
- (n) Internal auditor's signature with Membership Number.

A measure of uniformity in the form and content of the internal auditor's report is desirable because it helps to promote the reader's understanding of the internal auditor's report and to identify unusual circumstances when they occur.

19.8 Advanced Auditing and Professional Ethics

(1) Title: The internal auditor's report should have an appropriate title expressing the nature of the Report.

(2) Addressee: The internal auditor's report should be appropriately addressed as required by the circumstances of the engagement. Ordinarily, the internal auditor's report is addressed to the appointing authority or such other person as directed.

(3) Report Distribution List, Coverage and Opening or Introductory Paragraph: There should be a mention of the recipients of the report in the section on Report Distribution List. The internal auditor's report should identify the systems, processes, functional lines or other items of the entity that have been audited, including the date of and period covered. The report should include a statement that the operation of systems, procedures and controls are the responsibility of the entity's management and a statement that the responsibility of the internal auditor is to express an opinion on the weaknesses in internal controls, risk management and governance (entity level controls) framework, highlighting any exceptions and cases of noncompliance and suggest or recommend improvements in the design and operations of controls based on the internal audit.

(4) Scope Paragraph: The internal auditor's report should describe the scope of the internal audit by stating that the internal audit was conducted in accordance with generally accepted audit procedures as applicable. The management needs this as an assurance that the audit has been carried out in accordance with established Standards. "Scope" refers to the internal auditor's ability to perform internal audit procedures deemed necessary in the circumstances. The report should include a statement that the internal audit was planned and performed to obtain reasonable assurance whether the systems, processes and controls operate efficiently and effectively and financial information is free of material misstatement. The internal auditor's report, in line with the terms of the engagement, should describe the internal audit as including:

- (i) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;
- (ii) assessing the strength, design and operating effectiveness of internal controls at process level and identifying areas of control weakness, business risks and vulnerability in the system and procedures adopted by the entity;
- (iii) assessing the accounting principles and estimates used in the preparation of the financial statements; and
- (iv) evaluating the overall entity-wide risk management and governance framework.

The Report should include a description of the engagement background, internal audit methodology used and procedures performed by the internal auditor mentioning further that the internal audit provides a reasonable basis for his comments.

(5) Executive Summary Paragraph: The Executive Summary paragraph of the internal auditor's report should clearly indicate the highlights of the internal audit findings, key issues and observations of concern, significant controls lapses, failures or weaknesses in the systems or processes.

(6) Observations (Main Report) Paragraph: The Observations paragraph should clearly mention the process name, significant observations, findings, analysis and comments of the internal auditor.

(7) Comments from Local Management: The Comments from Local Management Paragraph should contain the observations and comments from the local management of the entity provided after giving due cognizance to the internal auditor's comments. This should also include local management's action plan for resolution of the issues and compliance to the internal auditor's recommendations and suggestions on the areas of process and control weakness/ deficiency. The management action plan should contain, inter alia:

- (i) the timeframe for taking appropriate corrective action;
- (ii) the person responsible; and
- (iii) resource requirements, if any, for ensuring such compliance. Further comments from the internal auditor, in response to the auditee feedback, are to be clearly mentioned. This paragraph should also contain the internal auditor's suggestions and recommendations to mitigate risks, strengthen controls and streamline processes with respect to each of the observations and comments made.

(8) Action Taken Report Paragraph: The Action Taken Report paragraph should be appended after the observations and findings and should include:

- (i) Status of compliance / corrective action already taken / being taken by the auditee with respect to previous internal audit observations;
- (ii) Status of compliance / corrective action not taken by the auditee with respect to previous internal audit observations and the reasons for non-compliance thereof; and
- (iii) Revised timelines for compliance of all open items in (b) above and fixation of the responsibility of the concerned process owner.

(9) Date: The date of an internal auditor's report is the date on which the internal auditor signs the report expressing his comments and observations.

(10) Place of Signature: The report should name the specific location, which is ordinarily the city where the internal audit report is signed.

(11) Internal Auditor's Signature: The report should be signed by the internal auditor in his personal name. The internal auditor should also mention the membership number assigned by the Institute of Chartered Accountants of India in the report so issued by him. Further, the internal auditor should exercise due professional care to ensure that the internal audit report, inter alia, is:

- (i) clear
- (ii) factual – presents all significant matters with disclosure of material facts
- (iii) specific
- (iv) concise

19.10 Advanced Auditing and Professional Ethics

- (v) unambiguous
- (vi) timely
- (vii) complies with generally accepted audit procedures in India, as applicable.

19.5.1 Essential features of a good internal audit report

The contents of an internal audit report are influenced by various factors such as the nature of internal auditing function in the organisation, level of reporting, degree of management support and capabilities of internal audit staff. However, for preparing a good internal audit report, the following general rules may be observed.

- (i) **Objectivity** - To maintain the credibility of internal audit function the comments and opinions expressed in the report should be as objective and unbiased as possible.
- (ii) **Clarity** - The language used should be simple and straight-forward. As far as practicable use of technical terms and jargon should be avoided. Each draft of the report should be reviewed by a senior who should attempt to read it from the point of view of the users of the report.
- (iii) **Accuracy** - The information contained in the report, whether quantified or otherwise, should be accurate. Where approximation or assumptions have been made the fact should be clearly stated along with reasons, if material.
- (iv) **Conciseness** - Brevity is vital subject, of course, to the condition that important information should not be omitted.
- (v) **Constructiveness** - Destructive criticism should carefully be avoided in the report. The report should clearly demonstrate that the internal auditor is trying to assist the auditor in an effective discharge of his responsibilities.
- (vi) **Readability** - The reader's interest should be captured and retained throughout. For this, appropriate paragraph heading may be used.
- (vii) **Timeliness** - The report should be submitted promptly because if the time lag between the occurrence of an event and its reporting is considerable, the opportunity for taking action may be lost or a wrong decision may be taken in the absence of the information.
- (viii) **Findings and conclusions** - These may be given either department-wise or in the order of importance. All the facts and data pertaining to the situation should be assembled, classified and analysed. Each conclusion and opinion should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices;
- (ix) **Recommendations** - An internal audit report usually includes recommendations for potential improvements. In order to enable the management to accept and implement the recommendations, the internal auditor should be able to convince the management that the conclusions are logical and valid and the recommendations represent effective and feasible ways of taking action.
- (x) **Auditee's views** - The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.

- (xi) **Summary** - A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.
- (xii) **Supporting information** - The internal auditor should supplement his report by such documents and data which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.
- (xiii) **Draft Report** - Before writing the final report, the internal auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his reports. It would also indicate whether there is any superfluous information or a gap in reasoning.
- (xiv) **Writing and issuing the Final Report** - The final report should be written only when the auditor is completely satisfied with the draft report. The head of the internal auditing department, may review and approve the final report. Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed.

19.5.2 Follow-up

The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time he should draw the management's attention to it.

Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons therefor. In cases where he finds that non-implementation is due to a gap in communication, he should initiate further discussion in the matter.

Where the management has accepted his recommendations and initiated the necessary action, the internal auditor should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly.

19.6 Relationship between Internal and External Auditors

The scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management. As stated earlier the internal auditor operates in various areas such as review of accounting system and internal control; examination of financial and operating information for the benefit of management, examination of the economy, efficiency and effectiveness of operations including non-financial controls of various tangible assets of the entity. While operating in these areas, there is lot of overlapping between the work of internal auditor and external auditor. The work done by internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets etc. is also required to be done by the external auditor. The function of an internal auditor is an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in

19.12 Advanced Auditing and Professional Ethics

consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers. Afterwards the procedures should be studied; also the scope of the audit examination carried out should be ascertained on referring to audit programmes, reports submitted, points raised in audit and how these had been dealt with subsequently. The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit. In a large business, it has been increasingly recognised that, if their functions and those of statutory auditors could be integrated, it might not be necessary for the statutory auditors to go over the same facts and figure as have been previously examined by a competent and trustworthy internal audit staff. But so far, the practice of audit being conducted jointly by the internal auditors is of great assistance to statutory auditors.

The role of the internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and thus much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures.

The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

By its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion of the financial information. The report of the external auditor is his sole responsibility, and that responsibility is not by any means reduced because of the reliance he places on the internal auditor's work.

SA 610 "Using the work of an Internal Auditor" deals with the relationship between internal and external auditors which is discussed in following paragraphs.

19.6.1 Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

- (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;***
- (b) The level of competence of the internal audit function; and***
- (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.***

The external auditor shall not use the work of the internal audit function if the external auditor determines that:

- (a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;*
- (b) The function lacks sufficient competence; or*
- (c) The function does not apply a systematic and disciplined approach, including quality control.*

19.6.2 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan.

The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly:

- (a) The more judgment is involved in:
 - (i) Planning and performing relevant audit procedures; and*
 - (ii) Evaluating the audit evidence gathered;**
- (b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;*
- (c) The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and*
- (d) The lower the level of competence of the internal audit function.*

The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

The external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with SA 260, communicate how the external auditor has planned to use the work of the internal audit function.

19.6.3 Using the Work of the Internal Audit Function

If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities.

The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:

- (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;*
- (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and*
- (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.*

24. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:

- (a) The amount of judgment involved;*
- (b) The assessed risk of material misstatement;*
- (c) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and*
- (d) The level of competence of the function as discussed above;*

and shall include reperformance of some of the work.

The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function and the determination of the nature and extent of use of the work of the function for purposes of the audit remain appropriate.

19.6.4 Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit

The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

The external auditor shall not use an internal auditor to provide direct assistance if:

- (a) There are significant threats to the objectivity of the internal auditor; or*
- (b) The internal auditor lacks sufficient competence to perform the proposed work.*

19.6.4.1 Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

- (a) The amount of judgment involved in:
 - (i) Planning and performing relevant audit procedures; and*
 - (ii) Evaluating the audit evidence gathered;**
- (b) The assessed risk of material misstatement; and*
- (c) The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance.*

The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

- (a) Involve making significant judgments in the audit;*
- (b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;*
- (c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or*
- (d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.*

Having appropriately evaluated whether and, if so, to what extent internal auditors can be used to provide direct assistance on the audit, the external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with SA 260, communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement.

The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

19.6.4.2 Using Internal Auditors to Provide Direct Assistance

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:

- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and*
- (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.*

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220.in so doing:

- (a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors of this SA; and*
- (b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.*

The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations no longer appropriate.

Finally, in India even the statute has now recognised that internal audit is necessary for efficient running of companies. Thus a review of the internal audit function in specified companies has become a statutory responsibility for the statutory auditor.

19.7 Management Audit

In recent years, the world has witnessed a rather new type of revolution viz. managerial revolution. Management of enterprises is itself a science and techniques and principles have been formulated for practising this science; a proper practice of this science will ensure an objective and efficient management of the affairs of any economic activity. This revolution has considerably changed the composition and outlook of management. Auditing has come to be viewed as an essential management tool, among others, for the efficient running of business and other economic activities. When we speak of auditing as a management tool, we give an extended coverage to the term auditing without, however, altering its basic concept. This extended concept of auditing includes operational auditing.

Auditing is generally associated with accounting activities or events. These activities or events are expressed in monetary terms. For this reason, we sometime try to take a narrow view of matters, that auditing is concerned with only the monetary accounting data. When we take this narrow view we lose sight of the fact that auditing basically and conceptually concerns itself with collection and appraisal of evidence underlying transactions that are quantifiable and not necessarily expressed in monetary figures. Auditing naturally looks to fields far more extensive than merely monetary accounts.

The emphasis of auditing has been changing over the years. It is now responding to a demand for more useful information that cannot be found solely in financial statements. In the late 1940's, for example, financial analysts and bankers showed a desire for information suitable for managerial appraisal. Today, stock holders, investors, government bodies, and the general public are seeking information by which the "quality of management" can be judged. As a result of this awakened interest of outsiders in judging the merits of organisations, there has arisen a similar movement from within organisations to judge the results of operations and their managers.



Fig.: Auditors discussing Management Audit*

19.7.1 Management and Operational Audit

The concept of operational audit is discussed in detail later in the chapter. Operational audit is an audit for the management; it is undertaken at the instance of the management for providing it with information and appraisal of operations and activities. A parallel development in auditing is getting shaped as management audit. In fact some of the authors do not see any difference between operational auditing and management auditing. They probably see that both these audits are for the management and cover operational areas that do not come under the review of the traditional audit. They are correct also to this extent. But they miss one important aspect of management audit, which has made it distinct from operational audit, i.e., management audit is an "audit of the management" also. According to T.G. Rose, "The management audit would therefore concern itself with the whole field of activities of the concern, from top to bottom, starting, as always where management control is concerned, from the top, because we are primarily concerned with whether the general management is functioning smoothly and satisfactorily. If it is not, it may be due to the functional management being faulty and, therefore, we pass on to examine that in its turn, in order to find the missing or faulty link which is causing the trouble".

From the very able conceptualisation contained in the above quoted passage, it is somewhat

* Source: Money Matters

19.18 Advanced Auditing and Professional Ethics

clear what should be the scope and content of management audit. It should definitely cover everything that we know as operational audit and, in addition it should also include review of the adequacy and competence of the objectives, plans, policies and decisions of the top management. However, as has been indicated above, unanimity is lacking on this aspect and management audit has become a subject of debate. John C. Burton, in the article "Management Auditing" (The Journal of Accountancy, May 1968) commented as follows:

"In a management audit, the auditor will look to see whether management is getting information relevant to the decisions and actions which it must take. This will require a much more intensive analysis of information needs and the efficiency of the existing system in meeting them. The auditor will not have to decide whether management is making the right strategic and operative decisions but rather whether management has available to it and is using the relevant information and techniques necessary to evaluate rationally the various alternatives that exist". Management audits are concerned with appraising management's accomplishment of organisational objectives; the management functions of planning, organising, directing, and controlling; and the adequacy of management's decisions and actions in moving towards its stated objectives. Hence, the accent is on evaluating managers' ability to manage.

19.7.2 Scope

From the authorities quoted above, it seems that the preponderant view about management audit is that it is wider in scope compared to operational audit. However, a distinction should be made between management audit and operational audit. Management audit is concerned with the quality of managing, whereas operational audit centres on the quality of operations. The basic difference between the two audits, then, is not in method, but in the level of appraisal. The two audits are complementary and supplementary to one another. In management audit, the auditor is to make his tests to the level of top management, its formulation of objectives, plans and policies and its decision making. It is not that he just verifies the operations of control and procedures and fulfilment of plans in conformity with the prescribed policies. He is to reach the root i.e., the functions of top management which lay down objectives and policies, provide means and procedures of implementation and control and which actually engage in direction and control on a continuous basis. In addition to what would normally be covered in an operational audit, management audit would also encompass the relevance and effectiveness of the aims, duties and decisions of management at various levels. Every aspect of the functions of Board of Directors should be in conformity with the objects set out in the constituting document. Similarly the managing director, if any, should act not only in accordance with the mandate he has received but he should ensure that the decisions he takes are in conformity with the objects of the company and the policies formulated by the Board. The effectiveness of management under the control of managing director and the various members of the Board including those incharge of finance, production, sales etc., should be subject to review of the management auditor. From the point of view of the management auditor, knowledge about the following is essential:

- (i) Purpose for which the organisation has been created. For example, purpose of a steel mill in the state sector may include:

- (a) production of steel to reduce imports of steel.
- (b) creation of reasonable employment opportunities.
- (c) development of backward areas.
- (d) providing staff welfare consistent with the needs for a proper living.

It should not be understood that such steel mill will not work for profit. Profit being one of the objects, should be properly balanced with other objects so that the purposes for which the organisation was created can be achieved.

- (ii) Management structure including delegation of authority, planning and budgeting.
- (iii) Reports required for a proper management and the reports actually received.
- (iv) Internal controls.
- (v) Nature of production of the business concerned in the broad way so that he can understand the flow and content of work leading to production and their mutual relationships. Some ideas about the techniques, formulas, raw materials and personnel requirement would be of direct assistance to the management auditor.
- (vi) Production planning.
- (vii) Factory layout, design and installed capacity.
- (viii) Personnel policy and personnel management including requirements, training, welfare, incentives and disincentives.
- (ix) Materials management including sources of important raw materials, receipt of materials of the quality and quantity needed, storage, supervision and safe custody, insurance and the procedure for issue of materials.
- (x) Sales management and sales planning including advertisement policy.
- (xi) Decision making process.
- (xii) Books and records including cost accounting records, cost accounting system and financial accounting policies.
- (xiii) Financial management of the organisation.

In view of the analysis made above which recognises management audit and operational audit as two identifiable exercises having a large area of overlapping jurisdiction, it may be convenient to consider them together to avoid duplication; and for this purpose the expression “management and operational audit” may be acceptable as a management audit which includes within its scope all the elements of operational auditing.

19.7.3 Desirability of Management Audit

Management Audit is a tool to improve management performance by recognising facts and information about management presented after appropriate examination, verification and evaluation, by professionally qualified and competent people. Management audit focuses attention on a comprehensive and constructive examination of the organisational structure, its

19.20 Advanced Auditing and Professional Ethics

components such as, divisions, departments, ventures, plans, policies, its financial control system, its method of operation, its appropriate use of human, physical and financial resources.

The principal reason for undertaking a management audit is the need for detecting and overcoming current managerial deficiencies (and resulting operational problems) in ongoing operations. A management audit represents a more positive, forward-looking approach that evaluates how well management accomplishes its stated organisational objectives; how effective management is in planning, organising, directing, and controlling the organisation's activities; and how appropriate management's decisions are for reaching stated organisation objectives. This evaluation of managerial performance is achieved with the aid of a management audit questionnaire.

One benefit of the management audit is that managerial problems and related operational difficulties can be spotted before the fact rather than after the fact as with a financial audit. This forward-looking approach is analogous to the preventive maintenance concept found in production; that is, periodic management audits can pinpoint problems as they are developing from a small scale. In comparison, detecting the same problem at a later time, when they have generally increased in scope, results in higher costs to the organisation.

A second important benefit of management auditing is that it represents another management tool to assist the organisation in accomplishing desired objectives. The capability of the management audit questionnaire to pinpoint important problem areas that are related to managing an organisation is a real plus factor for its use.

Obviously, management auditing would be clearly helpful in the case of ailing industries, to isolate the problems and account for their ailments. It is especially important if such industries are either to be taken over by the government or to be heavily financed by financial institutions with a view to bring back vigor in them. Before committing public funds, like government funds or the institutional funds, it is important to properly diagnose the financial health and possibilities of a business undertaking and know the specific reasons that have caused or contributed to the decline of the business.

19.7.4 Organising the Management Audit

The establishment of a general programme for management audit requires management's approval to the plan. Unless the management's full support is available for the proposal, there may be lot of difficulties at later stages. Therefore, it is imperative to give consideration to a statement of policy which indicates therein the objectives and which reflects a definite plan to achieve the objectives while organising for management audit. The plan should also include the statement on personnel requirements, establishment of staff training programmes to improve the effectiveness of work and the basis of control over time and cost. These, being the basic features are discussed below at length with related matters.

Devising the statement of policy - The management's support must be reflected clearly and categorically in the company's highest policy statement. The policy statement should be quite specific. It should spell out clearly the scope and status of the management/operational auditing within the enterprise, its authority to carry out audits, issue reports, make recommendations, and evaluate corrective action. The statement of policy should lay down in clear terms the scope

of activities to be performed by the management auditor. The scope of activities is the most basic requirement for building up a successful management audit programme both for small as well as a large organisation. The statement must categorically say that the management auditor is capable of reviewing administrative and management controls over any activity within the company. However, he should not be expected to extend his activities to the evaluation of performance of professional and technical activities calling for specialised knowledge and skills and suggest remedies unaided by people competent to undertake such evaluation.

Location of audit function within the organisation - Some organisations depending upon their size and nature have established a separate department of audit specialists where the head of the department reports directly to the top executive. In certain cases, the audit group may be a part of the activities of management services department, administrative control department or some other unit of organisation. The more important question, however, is that the function should be as entirely independent as possible of pressure from various groups in the enterprise. The greater the independence, greater is the freedom to work effectively. Therefore, it is better to place the auditing function quite high in the organisation.

One of the controversies that is usually raised is whether the management auditor should report to the finance director, to whom he may be administratively responsible or to the managing director where he has no administrative responsibility. A third opinion would like the auditor to report to an audit committee, comprising of senior executives of the company who are preferably Board members. A different school of thought would like auditors to report to both the finance director and the audit committee. Though the controversy rages and no definite solution can be arrived at, it is felt that the controversy regarding which of these persons the management auditor should report to is not much substance where independence exists. His independence is entirely dependent on the management's attitude towards audit, the credibility the management auditor has with the management and the management's positive will to listen to criticism for self betterment.

Allocation of personnel - Whatever be the size of the enterprise, it is important that all persons selected and assigned to audit possess a good understanding of auditing theory, a thorough knowledge of the fundamentals of both organisation and management, the principles and effective methods of control, and the requirements for conducting scientific appraisal. "General Guidelines on Internal Auditing" issued by the Institute also emphasizes these qualifications for an auditor whose area extends beyond the review of financial controls. As the management auditor is expected to evaluate operational performance and non-monetary operational controls, he should possess basic knowledge of the technology and commercial practices of the enterprise, an enquiring, analytical, pragmatic and imaginative approach and a thorough understanding of the control system. The management auditor should also have a basic knowledge of commerce, law, taxation, cost accounting, economics, quantitative methods and EDP systems. Knowledge in these areas would be adequate for him to identify problems and to determine steps to be taken when a problem is identified. In personal characteristics individuals assigned to the job should have an inclination towards analysis, a high degree of imagination and an ability to write and express themselves clearly and logically.

19.22 Advanced Auditing and Professional Ethics

Staff training programme - A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep of new ways to improve auditing standards. An effective training programme enables staff to assume additional responsibilities and advancements in the organisation. Thus the programme acts as an incentive for drawing capable people into the department and keeping them.

Time and other aspects - The time and cost will vary for each assignment, depending upon the nature of the assignment, the number of auditors assigned to perform the work, and whether or not more specialists in a particular field are required. An audit of a production planning and control department, for example because of its size and other factors, could require an audit staff of several persons and, in addition, a specialist in production planning and one in production control. If an assignment is one which requires technical assistance of a nature unavailable within the audit group, it might be advisable to seek a qualified outside consultant to perform the work.

Frequency - Having specified various approaches to management audit, including its scope and its staffing requirements the last item that should be considered before undertaking such an audit is its frequency. Prime consideration should be given to the nature of the organisation. Is the company in a fast-changing industry where there is great accent on the latest technology in the company's products and/or services? When the organisation is subject to rapid change or the total resources utilised are expensive, the frequency of management auditing should be greater than when it does not undergo rapid changes or the resources employed are not high in value.

To get an idea of the optimum frequency of such an audit, it might be worthwhile to look at financial audits. Customarily, financial audits are conducted annually. They are highly programmed, since an internal control questionnaire is utilised to attest to accounting methods and procedures. By contrast, a management audit should be considered from a longer time frame. For an organisation, that is subject to rapid changes or consumes a great amount of high-cost resources, a two-years basis might be adequate to protect it from managerial and operational problems becoming entrenched or too large. For those organisations in a relatively stable industry, the frequency of audit can be every three years. In no case should the interval be allowed to exceed three years.

19.7.5 Conducting a Management Audit

Once top management has decided on the scope, the staffing, and the frequency of the management audit, the next phase is the undertaking of actual audit. This involves investigating and analysing the present facts through interviews as well as completing a management questionnaire so as to determine the problems confronting the organisation.

Getting the facts through interviews - To avoid waste of time and effort, adequate preparation is necessary in management auditing just as in financial auditing. The management auditors should know what information is desired, and they should be prepared to ask a number of direct questions to get the desired information. Reference can be made to the management audit questionnaire for specific questions. Care must be taken in selecting the proper managers to interview so as to obtain pertinent information.

In the interview itself, the auditors should begin by stating the purpose of the audit. Emphasis should be placed on getting the facts that are essential to review and appraise the functional area(s) under study. The exchange between auditor and manager should be friendly and conducted in an open atmosphere so as to encourage a free exchange of ideas. During the interview, management auditors should not commit themselves, nor should any recommendations be set forth at this time. Once all pertinent information has been extracted from the interview, it is advisable to verify the accuracy of information by requesting the person interviewed to read the notes taken and place his or her initials thereon. This extra step makes the individual feel an important part of management audit.

Measuring performance through the Management Audit Questionnaire - During the interview, the management auditors make a careful inquiry into important facts. The next step is to analyse this information, with the aim of measuring current performance. The best way to perform such an analysis is to utilise the sections of the management audit questionnaire that apply to the areas under study. By way of review, a management audit questionnaire aims at a comprehensive and constructive examination of an organisation's management and its assigned tasks. Overall, the questionnaire is concerned with the appraisal of management actions in accomplishing organisation objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation for possible improvements.

Management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesise those elements that are causing organisational difficulties and deficiencies. To state it another way, a synthesis (a process of combining separate elements) can be used for determining the problem. The capability to assess all negative answers goes a long way towards defining the real problem-not just stating its symptoms.

19.7.6 Concluding a Management Audit

The preparation of the management audit report that covers the details of the management auditor's findings and recommendations represents an important part of concluding an audit assignment. To assist in the preparation of the final report, the management auditors normally meet with management and other concerned personnel for the purpose of discussing freely any aspect or finding of the audit. This approach assists the independent third party in bringing together the important elements of audit as well as determining appropriate recommendations. Also, it will disclose any "hang-ups" that organisation personnel may have towards a particular solution. It is far better to discuss alternative recommendations and feel out the possible consequences of recommended action. However, it should be noted that the type of report required varies with the level of investigation. Thus, a comprehensive investigation involves a report that is very broad in scope, while a smaller-scale investigation of one or two functional areas will result in a less comprehensive report.

Oral recommendations for improvement - From the management viewpoint, the main focus of audit is recommendations. Generally, there is an oral presentation of specific recommendations to members of the top management team who approved the audit. In some cases, the approval may have come from the board of directors, which then becomes the

19.24 Advanced Auditing and Professional Ethics

recipient of the auditors' oral recommendations. Upon completion of the presentation, oral recommendations become an integral part of the final report- the subject matter for the next section.

In the oral presentation, recommendations representing feasible solutions that will be accepted without too much difficulty are discussed initially. The auditors should back these recommendations with a cost/benefit analysis that indicates the expected return to the organisation from implementing them. The interchange of ideas among management and the auditors allows for a logical development of appropriate dates for implementation. Additionally, it assists management auditors in drawing up an implementation time-table for inclusion in their final report.

19.7.7 Management Audit Reports

The written report is the medium by which the comments, criticisms and recommendations of a management audit department are conveyed to the Board, to functional directors and to management in general. It follows, therefore, that audit reports crystallise the work of the management auditor and merit the closest consideration of all audit staff engaged in their preparation. Reports must be written with very great care after full consideration of the subject matter and with full regard to the fact that it is imperative that the report conveys exactly the right impressions on the reader. Management audit reports will inevitably cover a wide variety of subjects, reflecting the many and ever increasing ramifications of management audit departments. Broadly, however, reports may be divided into four main categories:

1. Reports prepared by the management audit staff after their visits to a unit.
2. Periodical reports prepared by senior members of management audit department which summarise the main audit findings and recommendations for the period under consideration and which afford a concise review of the department's activities for that period.
3. Reports on the results of special investigations and inquiries.
4. An annual audit report.

The right of the management auditor to report to the highest level is now well established in many organisations but in all cases responsible officials of the different units which have been subjected to audit should be afforded the opportunity of discussing matters in the report concerning their departments before this is passed in final form to a higher level.

Types of Reports - The reporting of results covers a wide spectrum of types. We can describe the more important ones as follows:

Oral reports - In many situations, the reporting of results will be on an oral basis. To some extent, this is inevitable since a part of the actual audit effort is carried on in conjunction with company personnel. In other cases, it is a result of emergency action needs. It may also be a prelude to more formal written reports. To some extent, there will always be oral reporting as a means of later supplementing written reports, especially when individuals being served have special needs.

Oral reporting therefore, serves a useful and legitimate purpose. It is recognised that it has a major limitation that there is no permanent record. As a result there are more likely to be later misunderstandings. What is important, therefore, is that this type of reporting be used carefully and for all significant matters, specially the matters covered by emergency oral reporting, should be followed up immediately by a written report giving reference to oral reporting. For example, a management auditor, if he has come across any embezzlement, should immediately inform the concerned management orally, so that steps may be immediately taken to prevent further embezzlement.

Interim written reports - In situations where it is deemed advisable to inform management of significant developments during the course of the audit, or at least preceding the release of the regular report, there may be some kind of interim written report. This report may pertain to especially significant problems where there is a need for early consideration or the report may be of a progress nature. In either case, they may be quite formal in nature or of the more informal type of current memoranda. They can be reserved for very exceptional developments, or issued on a more extensive basis. Often, their distribution is limited to this auditee management, but this is not necessarily the case. All in all, interim reports represent a type of reporting which, when used with judgement, can be a good device to improve the total reporting process.

Regular written reports - In the typical situation, the particular audit assignment will include the preparation of a formal written report. The form and content of such written reports will vary widely, both as between individual audit assignments and individual companies. They may be short or long. They may be presented in many different ways, including the extent to which quantitative or financial data are re-included. We will in the later pages discuss in more detail the organisation and planning of this type of report.

Summary written reports - These summary reports are also referred to as 'flash' reports. In a number of companies the practice has developed of issuing an annual (or sometimes more frequent) report summarising the various individual reports issued, and describing the range of their content. These summary reports in some cases are primarily for audit committees of Boards of Directors, but in other cases for higher level management. They are especially useful to top level managers who do not actively review the individual reports. They are also useful to the general auditor in seeing his total reporting effort with more perspective and on an integrated basis.

Organisation of the written report -

Format - Though it is difficult to lay down a format applicable to all situations, yet the following general guidelines may be observed:

- (i) **Title** - The management audit report should have a short but descriptive title so that its subject matter can be easily identified.
- (ii) **Objectives** - The management auditor may describe the objectives of the audit assignment.
- (iii) **Scope** - The management auditor may give a brief description of the activities audited by him.

- (iv) **Findings, conclusions and opinions** - These may be given either department wise or in the order of importance. All the facts and data pertaining to the, situation should be assembled, classified and analysed. Each finding should be discussed comprehensively and correlated with other findings. Conclusions and opinions should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices.
- (v) **Recommendations** - A management audit report may include recommendations for potential improvements. However, care should be taken in making recommendations in order that the auditor's own objectivity may not become subject matter of question. He may point out defects and make recommendations in a broad manner on how to overcome them. He should avoid providing detailed procedures in the capacity of an auditor. Normally specifying procedures etc. should rest with consultants.
- (vi) **Auditee's views** - The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.
- (vii) **Summary** - A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.

Planning the Audit Report - Before starting the report, the auditor should ask himself, "What do I want to tell the reader about this audit? The answer will enable him to communicate effectively.

Supporting information - The management auditor should supplement his report by such documents and data which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.

Preparing draft report - Before writing the final report, the auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his report. It would also indicate whether there is any superfluous information or a gap in reasoning.

Writing and issuing the final report - The final report should be written only when the auditor is completely satisfied with the draft report. The head of the management auditing department may review and approve the final report. Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed and dated.

Follow-up of the audit report - The management auditor should review whether follow-up action is taken by management on the basis of his report. If no action is taken within a reasonable time, he should draw management's attention to it.

Where management has not acted upon his suggestions or not implemented his recommendations, the auditor should ascertain the reasons therefor. In cases where he finds that non-implementation is due to a gap in communication, he should initiate further discussions in that matter. Where management has accepted his recommendations and initiated the necessary action, the management auditor should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly. Any non-implementation of

the management auditor's report in continuing assignments, after having convinced that the communication of the report was complete should be earnestly taken up because on this the credibility and usefulness of the audit function largely depends. It also reflects management's attitude to audit. In any case, the auditor to retain the usefulness of audit function should ascertain from the management, preferably in writing, the reasons for non-implementation. It is possible that because of change in circumstances, the audit observation did not require any action on the part of the management.

19.7.8 Behavioural aspects encountered in a Management Audit

It has been experienced that one of the biggest difficulties involved during the course of management audit is that people working in the organisation do not wish to accept any change. While at the time of conducting interviews, it seems that people working in the organisation are amenable to change but at the time of actual implementation they come up with stiff resistance to proposals on account of various behavioural problems arising on this account. Such an unfortunate situation can be avoided by building up a positive approach to management audit and involving the various organisation personnel right from the initiation of the management audit. Another fear which haunts executives working in the organisation is that the management auditors' recommendations may lead to their removal or reshuffling in the process. This problem may also be overcome by explaining to these executives that the management auditor is there to help them in achieving the results rather acting against their interests. Various problems arising on account of behavioural attitudes and solutions to overcome them during the process of management audit are discussed in the following paragraphs.

Financial auditors deal mainly with figures. Management auditors deal mainly with people. Management auditors in the normal discharge of their duty will come into contact with the following:

- (a) Colleagues in their own department.
- (b) Staff of the department whose functioning they audit.
- (c) "Top management" who authorise them to perform audits.

Therefore, management auditors must develop and maintain good relations with auditees to gain information and to ensure corrective action on audit findings. Yet, the general image that the auditor seemed to create is that he is a critic, fault finder or private spying authority of the top management. There are many causes for behavioural problems arising in the review function of management/operational audit. Particularly, when management/operational auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. However, it must be emphasised that other departments which have only staff function to perform do have similar behavioural problems. Any suggestions made by them either may not be accepted or if forcibly implemented attempts are like to be made to make them a failure. In the following paragraphs, the nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed.

19.28 Advanced Auditing and Professional Ethics

(1) **Staff/line conflict** - The staff/line relationship is inherently prone to conflict. Management auditors are staff. And line people in the sense all members of other departments of the organisation are likely to regard the management auditor the same way as they regard other staff people. Management auditors being specialists in their field may think that their approach and solutions are the only answers.

(2) **Control** - As the management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee to have certain amount of fear that his actions when reported are likely to cause adverse effect on those who receive the auditor's report, viz., top management. There is a certain amount of justified fear that top management's opinion of their performance or implementation of control procedures is likely to be affected by the auditor's report. Therefore, the management auditor, being the part of control system and thorough evaluation of controls, leads to breeding of antagonism on the part of the auditees. According to a research study, the causes of antagonism are as follows:

- ◆ Fear of criticism stemming from adverse audit findings.
- ◆ Fear of changes in day-to-day working habits because of changes resulting from audit recommendations.
- ◆ Punitive action by superiors prompted by reported deficiencies.
- ◆ Insensitive audit practices - reports which are overly critical, reports which focus on deficiencies only, the air of mystery cloaking some audits, and the perception that auditors gain personally from reporting deficiencies.
- ◆ Hostile audit style - a cold and distant aspect is a lack of understanding of the auditee's problems, an absence of empathy, an air of smugness or superiority, an excessive concentration on insignificant errors, a prosecutorial tone when asking questions, and a greater concern with parading defects than helping constructively to improve conditions.

The other significant cause is that auditor's study of existing systems and procedures may give room for recommendations for changes of such systems. There is a certain built-in resistance to change. When a change is recommended by the auditor the resistance to change is transferred to the auditor's recommendations and the auditor. The auditor is looked upon as a likely instrument for recommending changes and auditees do not welcome the visits of auditors and much less their studies and their reports thereafter.

Solution to behavioural problems - The auditors, if they were to adopt the role of accuser or secret agency of the management to try upon the happenings of the auditee division, they would be unwelcome. Their presence will give rise to problems of personal relationship. Relations between the auditor and the auditee may improve if the auditor acts and is perceived as a professional advisor and consultant. In any event, there is a need to demonstrate to the extent possible that:

1. the audit is part of an overall programme mandated by higher-level authority to meet higher-level organisational needs for both protection and maximum constructive benefit.

2. the objective of the review is to provide maximum service in all feasible managerial dimensions.
3. the review will be conducted with minimum interference with regular operations of the operating personnel.
4. the responsible officers will be kept fully informed and have an opportunity to review findings and recommendations before any audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Davis and Scott in their book on "Human Relations and Organisational Behaviour" had suggested that being effective does not merely consist of being extremely polite. "Effectiveness is a difficult task requiring the highest mental ability and sound framework for analysing human situations". In view of the delicate role of the auditor, it is inevitable that he has to face complex situations. The skill that is needed is of a high order warranting "sophisticated understanding based on sound philosophy".

Constructive criticism - It is essential that the auditor should concentrate only on constructive criticism. He should also make obvious in his report the value of his comments in tangible terms. Only then would suggestions carry weight with the auditees and they will feel convinced that the auditor has been objective in his remarks in the report. T.J. Krien in his article on "People assets that talk back" has strongly advocated the view that once the auditor is able to convince the auditees that his approach is one of mutual problem solving rather than one of fault finding, then it would produce positive results and the chances of auditors' recommendations being considered in an objective fashion would be better. If the auditors were to adopt a "fault finding role", the auditees would be constrained to become defensive and would bend backwards to justify their position.

Reporting methods - To achieve this objective, the auditor has to make a concerted effort to convey effectively his role by adopting a friendly but firm tone in his report. It is always possible to disagree without being disagreeable, to criticise without being critical. The reports should concentrate on areas which need improvement rather than listing inefficiencies and deficiencies in performance of the auditee. The mistaken notion that the greater the number of deficiencies reported the higher would be the rating of his performance should be erased or given up. This is an outdated notion and does not in any way contribute to the effectiveness of the auditor.

Participative approach - It is well established that auditor's reports have better acceptability if the improvements suggested are discussed with those who have to implement them and made to feel that they have participated in the recommendations made for improvements. Harmeyer W.J. in his article on "Operational audit: You too can be a Consultant" has reasoned that by adopting a participative approach the chances of improvements being accepted and implemented successfully with conviction are very good. In his work, he has effectively described the concept as follows. "By utilising this participation you end up with coordinated suggestions for improvement not with the auditor's recommendations". W.T. Jerome also voiced the same view in his article in Harvard Business Review long back. He very correctly pointed

19.30 Advanced Auditing and Professional Ethics

out that “auditors must candidly recognise that they are appraising many deficiencies from the distorting vantage point of hindsight. If they recognise this limitation by soliciting the views of operating personnel, internal auditing becomes a co-operative enterprise, it will not then be regarded as the “secret police” of the home office.” On the other hand, it has been observed that either oral or written appreciation of the auditee’s achievements not only encourages the auditees to develop a friendly attitude towards the auditors but look forward to their guidance in a more receptive fashion.

The participative approach to the internal audit process has proved to be success. Well-known authorities in the field have proved by means of research they have conducted that resistance to change is absent if not minimal when participative method is adopted. Feelings of hostility disappear giving room to feelings of mutual trust. Team spirit is developed and the auditors and the auditee endeavour to achieve the common goal. Proposed recommendations are discussed with the auditee and such modifications as may be mutually agreed upon are incorporated.

Three cases are given hereunder to illustrate the practical aspects of behavioural problems.

Case-1: Auditor objective: Auditee offensive: Management’s apathy - In Professional Organisation Ltd., the Management Auditor as part of his duty was expected to perform the audit function of the Consultancy Division of the organisation. The auditor in the normal functioning discovered lack of control and a further study revealed suppression of information regarding illegal procedures being followed by the department. His further in-depth examination of the books revealed that the division has been overstating profits, to justify its existence. These facts which had been in existence with the knowledge of manager of the Division had been left undetected. The auditor was totally professional. His attitude was not one of “policing”. He had discussed the contents of his proposed report with the auditee. The auditee had to be defensive and hence decided to be offensive. Management had to face the predicament of appreciating the good job done by the management audit department without openly decrying the Divisional Manager. There was open “cold war” of hatred and hostility declared by the divisional Manager. The behavioural problems arose in spite of auditor’s professional role. The auditee’s reaction was instinctive as a corollary to being self-defensive. The management had a tough time. The problem was sorted out and the atmosphere of ill-feeling and hatred generated by the auditee could be smoothened.

Case-2 Auditee progressive: Auditor cantankerous: Management indifferent - In a large organisation, there was a long-standing problem of lack of coordination between marketing and production. The pressures of day-to-day problem, made the situation worse. Production and Marketing Managers were happy to have the services of the management, auditor to streamline procedures and monitor the implementation. It would have been ideal for the auditor to evolve a good system after a detailed study of the problems, have the key personnel of production and marketing departments participate in the discussion and to have introduced the proposed system with their co-operation. Instead the auditor took on his duty as a mission for fault finding and started submitting secret reports on the malfunctioning of the Production and Marketing departments. Management, having already the heavy load of coordination would seek explanations from Production and Marketing departments. The auditor’s cantankerous

behaviour and management's indifferent attitude inspite of auditee's very co-operative approach gave room for a series of behavioural problems. A participative approach, with the total curtailment of "policing" reports, with the correct guidance from the management would have avoided all behavioural problems.

Case-3 Auditor progressive- Auditee appreciative: Management objective - In a large organisation with operations spread all over the country the management faced sudden problems of lack of financial control, inspite of high levels of production and remarkable market demand. The organisation had an efficient and progressive management auditor with a good team. The auditees were individuals with professional attitude. Management was progressive and dynamic. Management called for meetings, explained the special assignment being given to management auditor of aiding management to get a grip over the situation. The auditee welcomed the auditor as an expert consultant. The auditor adopted an attitude of friendliness without descending to levels of too much familiarity. There was coordinated effort between the auditor and auditee. Management was kept informed of the problems and solutions being jointly worked out by the auditors and the auditees. Within a very reasonable time, what seemed an "out of control" situation was streamlined and the management got back the grip over the entire organisation.

19.8 Operational Audit

Operational auditing is a systematic process involving logical, structured and organized series of procedures.

19.8.1 Internal Auditing and Operational Auditing

To understand what operational auditing is, it would be better if we first understand internal auditing. It may be recalled that internal auditing is an activity carried on by the internal staff of an organisation to meet the management requirements of information. The definition of internal auditing given by the Institute of Internal Auditors (IIA), New York, in fact equals internal auditing with operational auditing. According to this definition, internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to organisation. Naturally, when an auditor is concerned with the appraisal of operations, he becomes an operational auditor. Another important point that this definition throws up is that operational auditing is essentially a function of internal auditing staff. According to the Institute of Internal Auditors, "the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and pertinent comments, concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to managements".

IIA publication defines operational auditing as - Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management's control and reporting to appropriate persons the results of the evaluation along

19.32 Advanced Auditing and Professional Ethics

with recommendations for improvement¹.

On the basis of above definition operational auditing is a systematic process involving logical, structured and organized series of procedures. Operational auditing concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvement in future.

At this stage it must be conceded that operational auditing is a newly emerged term and therefore liable to be understood according to individual perceptions about what it is or should be. It may, therefore, take some time to have a generally accepted conceptualisation on this. However there probably may not be much of difference in viewing operational audit as a review and appraisal of operations of an organisation carried on by a competent independent person. The question of competence is implicit in any auditing situation; unless one is well-conversant with the philosophy, techniques and procedures of audit, one cannot do justice to the work of audit. Similarly auditing whether carried on by an internal staff or by an external person, should necessarily be an independent activity to maintain its objectivity and usefulness. According to Cadmus "Operational Auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas. And it is characterised in both financial and operational areas - by the auditor's approach and state of mind". The difference in the approach of both these audits is illustrated below:

Perception - Traditionally, internal auditors have been engaged in a sort of protective function, deriving their authority from the management. They view and examine internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they check the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable. They also look into the aspect of safety of the assets and properties of the company. To a traditional internal auditor, a loss of ₹ 1,000 caused by a wrong totalling of invoice is important and this is that he looks for. But for an auditor engaged in the review of operations, carrying out of a proper maintenance programme of the machines is of greater importance because considerable production loss due to machine breaks down can thus be prevented. In both the cases, the auditor's objective is to see that the business and its profitability do not suffer from avoidable loss, but, nevertheless, there is a distinct difference in approach.

Take another instance - when the auditor looks into the vouchers to see whether they corroborate the entries in the cash book or physically examines the cash in hand he is doing his traditional protective function. The moment he concerns himself to see whether customers' complaints are duly attended to or whether cash balance is excessive to the need, he comes to the operational field.

It should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of

¹ Darwin J. Casler and James R. Crockett, operational Auditing. An Introduction (Altamonte Springs, FL: The Institute of Internal Auditors, Inc., 1982). P 14.

transaction and controls. A point has already been made that the special expertise acquired by the operational auditor, that enables him to view the controls and operations from the management point of view, can be carried back to his review of the financial areas. In the matter of cash transactions, the operational auditor will look into such aspects as the quantum of cash in hand (by relating it to the requirement of cash to be held) carried generally or the use of cash not immediately required. Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would be interested in such matters as reorder policy, obsolescence policy and the overall inventory management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

Issues - The basic difference that exists in conceptualisation of the technique of operational auditing is in the auditor's role in recommending corrections or in installing systems and controls. According to Lindberg and Cohn, such a situation would be in conflict with the role of operational auditor. One cannot objectively review an operation, control or a system recommended by him and in fact this should be left to be dealt by methods and procedures people. In this connection, the views of the Institute of Internal Auditors, in the context of internal audit are relevant. According to that Institute, "the internal auditor should be free to review and appraise policies, plans, procedures and records; but his review and appraisal does not in any way relieve other persons in the organisation of the responsibilities assigned to them. The Institute has further held that "since complete objectivity is essential to the audit function, internal auditors should not develop and install procedures and systems, prepare records or engage in any other activity which they normally would be expected to review and appraise". It may be remembered that the definition of internal auditing given by this Institute is same as operational auditing. Therefore, the views quoted above equally apply to operational audit *per se* and Lindberg and Cohn's views are not different from these in this respect. Also there does not appear to be much conflict of views in understanding operational auditing as an extension of internal auditing with a definite work content which stretches beyond the traditional field of internal auditors i.e. financial accounting. However, a further distinction should be observed between traditional internal auditing and operational auditing - this lies in the attitude and approach to the whole auditing proposition. Every aspect of operational auditing programme should be geared to management policies, management objectives and management goals.

Objectives - The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems and prospects and its environment. Above all, his mind should be open and active so as to be able to perceive problems and prospects and grasp technical matters. In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues; he will have to get the assistance of norms and standards in every operating field to be able to objectively judge a situation. The norms and standards should be such as are generally acceptable or developed by the company itself.

19.34 Advanced Auditing and Professional Ethics

Performance yardsticks can be found in the management objectives, goals and plans, budgets, records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments. For example, the standards relating to objectives for a government company are quite different from those of a private sector company. Similarly standards of performance of a well equipped company which also adequately looks after the well-being of employees may be significantly different from a company which offers scanty welfare facilities or is ill-equipped. Today, however, the concept of modern internal auditing suggests that there is no difference in internal and operational auditing. In fact, the scope of internal auditing is broad enough to embrace the areas covered by operational auditing as well. The modern internal auditing performs both protective as well as constructive functions.

19.8.2 Qualities of Operational Auditor

The operational auditor should possess some very essential personal qualities to be effective in his work. In areas beyond accounting and finance, his knowledge ordinarily would be rather scanty and this is a reason which should make him even more inquisitive. He should ask the who, why, how of everything. He should try to visualise whether simpler alternative means are available to do a particular work. He should try to see every thing as to whether that properly fits in the business frame and organisational policy. He should be persistent and should possess an attitude of skepticism. He should not give up or feel satisfied easily. He should imbibe a constructive approach rather than a fault-finding approach and should give a feeling that his efforts are to help attaining an improved operation and not merely fault finding. He should consider a fault or mistake found in the course of audit more as a guide to effect improvement than to treat the fault as a sort of crime. If the auditor succeeds in giving a feeling of help and assistance through constructive criticism, he will be able to obtain co-operation of the persons who are involved in the operations. This will itself be a tremendous achievement of the operational auditor. He should try to develop a team comprised of people of different backgrounds. Involvement of technical people in operational auditing is generally helpful.

19.8.3 Why Operational Audit?

The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation. Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the departments all of whose activities do not come under direct observation of managers. The shortcomings of these sources can be stated as under:

- (i) Executives and managers are too preoccupied with implementation of plans and achieving of targets. They are left with very little time to collect information and locate problems. They may come across problems that have come to surface but they are hardly aware of problems that are brewing and potential.
- (ii) Managers or their aides are generally relied upon for transmitting information than for booking for information or for analysing situations.
- (iii) The information that is transmitted by managers is not necessarily objective - often it may be biased for various reasons.
- (iv) Conventional internal audit reports are often routine and mechanical in character and have a definite leaning towards accounting and financial information. They are also historical in nature.
- (v) Other performance reports contained in the annual audited accounts and the routine reports prepared by the operating departments have their own limitations. The annual audited accounts are good insofar as an overall evaluation is concerned in monetary terms. But they may not bring to light specific problems in different operational areas so readily. Sales may be shown at a higher monetary value compared to the previous year and this may apparently suggest that the functioning of the sales department is satisfactory. But this may have been caused by a number of factors in spite of a really bad performance on the sales front. This fact may not be readily known unless one cares to analyse the sales data by reference to notes and explanations to the accounts and other related accounting data. Even a study of this nature may not fully reveal the weakness. It is quite possible that the established market for sales has been lost partly while some fortuitous sales have compensated the loss. The other routine departmental reports definitely serve a purpose of more or less currently informing the management about the departmental performance. But the reports are not always objective and have a definite tendency to colour the departmental performance favourably. For example, the routine weekly production report may include production 'that is subsequently rejected by the quality control staff, or to avoid showing a bad production performance; even the partly produced goods may also be included. Remember, all this can happen in spite of specific management instructions about the basis on which the production report is to be made out.

Another important point may be noticed in the matter of routine departmental reports. The despatch section, to show a good performance, may show goods handed over to the transport section which, even within its knowledge, may not be really despatched within the next several days, because of accumulation of goods at the transport shed or because of non-availability of wagons or shipping space. It may be appreciated that those reports may or may not contain a falsehood; but, definitely, they do not show performance in the proper light in relation to allied activities and thereby the problems of one area are merely shifted to the next. They fail to provide insight into particular problems that may be growing elsewhere in the organisation. The busy management people, who can afford time only to glance over the performance reports, cannot be expected to make an integrated reading of several reports or to undertake an analysis of such reports. What they need is reliable,

19.36 Advanced Auditing and Professional Ethics

unmanipulated and objective report which they would like to look into to understand the situation.

- (vi) Operations of controls in a satisfactory manner cannot be relied upon to bring to light the environmental conditions. Controls are specific and their satisfactory operation is related to the specific situation under control. Also monitoring of the breakdown or non-operation of controls is a periodic phenomenon.
- (vii) Surveys and special investigations no doubt are very useful but these are at the best occasional in character. Also, they are costly, time consuming and keep the departmental key personnel busy during the period they are on. They are undertaken mostly to find causes of certain state of affairs or to fix responsibility for certain undesirable happenings. These are basically an attempt to carry out a post-mortem rather than to enlighten the management about the ways on improvement or for better performance or to give a signal for dangers and disasters to come.

19.8.4 Type of Operational Audits²

There are three broad categories of operational auditors: functional, organizational, and special assignments. In case, part of the audit is likely to concern evaluating internal controls for efficiency and effectiveness.

Functional Audits - Functions are a means of categorizing the activities of a business, such as the billing function or production function. There are many different ways to categorize and subdivide functions. For example, there is an accounting function, but there are also cash disbursements, cash receipt, and payroll disbursement functions. There is a payroll function, but there are also hiring, timekeeping, and payroll disbursement functions. As the name implies, a functional audit deals with one or more functions in an organization. It could concern, for example, the payroll function for a division or for the company as a whole.

A functional audit has the advantage of permitting specialization by auditors. Certain auditors within an internal audit staff can develop considerable expertise in an area, such as production engineering. They can more efficiently spend all their time auditing in that area. A disadvantage of functional auditing is the failure to evaluate interrelated functions. The production engineering function interacts with manufacturing and other functions in an organization.

Organizational Audits - An operational audit of an organization deals with an entire organizational units, such as a department, branch, or subsidiary. An organizational audit emphasizes how efficiently and effectively functions interact. The plan of organization and the methods to coordinate activities are especially important in this type of audit.

Special Assignments - In operational auditing, special assignments arise at the request of management. There are a wide variety of such audits. Examples include determining the cause of an ineffective IT system, investigating the possibility of fraud in a division, and making recommendations for reducing the cost of a manufactured product.

² Auditing and Assurance Services by Arens, Elder & Beasley; prentice hall publication, 2003 edition, page 740.

19.8.5 Objectives of Operational Audit

Like internal auditing, the scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Without a combination of these two, operational auditing may not be able to show its distinctively and advantages to the organisation. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different organisations. Generally, operational audit objectives include:

- (i) Appraisal of controls,
- (ii) Evaluation of performance,
- (iii) Appraisal of objectives and plans, and
- (iv) Appraisal of organisational structure.

The most significant gain an organisation can derive from operational auditing is probably in the area of appraisal of controls. Internal controls, because of their unobtrusive omnipresence in the organisation, provide the essential hinges to ensure proper performance in each functional or organisational area for accomplishing the desired organisational objective. If the hinge of a machine is weak or broken however costly or good that machine may be, it will not perform with any degree of efficiency. Similarly, if controls are weak or breaking down, however well equipped or well-manned the organisation may be, it will fail to operate effectively.

In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. Apart from this, the operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance, the operational auditor's mind is invariably fixed on control aspects. For example when he walks through the factory floor, amongst others, he observes whether machines are idle or workmen not present in the post assigned to them or the accumulation of stores on the floors All these have a bearing on the operation of controls. He can then go into the reasons of the failure of controls and bring these to the attention of the management for verification in the interest of proper working in future. He reviews internal control reports to ascertain whether they bring the performance, qualitatively and quantitatively to the notice of the management; also whether the organisation's policies and plans are being carried out.

In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on. He prepares his evaluation programme in such a manner that it will show how well or how poorly the department has fared by reference to applicable standards, procedures, rules, policies and plans. The principal basis of performance evaluation can be productivity, personnel, workload, cost and quality.

19.38 Advanced Auditing and Professional Ethics

In the area of *productivity*, the operational auditor can undertake such tests as input-output ratios for materials and labour in quantitative terms.

In the sphere of physical production the auditor will, in most cases, get the advantage of having some acceptable norms or standards. For other spheres, such measures as man-hours per customer or man- hours per application processed can be adopted. What measure is appropriate on what occasion is a matter to be judged by the auditor and he can evaluate performance by reference to the selected measure. Apart from these, the auditor has to consider the following broader aspects also in performance evaluation:

- (i) How does productivity compare with the prior period?
- (ii) At what level should productivity be to meet the target?
- (iii) What are the factors affecting productivity?
- (iv) Is the level of production commensurate with the flow of orders received?
- (v) Is unsatisfactory production performance the result of :
 - (a) non-availability of raw materials?
 - (b) inadequate or unskilled personnel?
 - (c) lack of proper supervision?
 - (d) lack of proper machine maintenance?
 - (e) strikes and/or lockout?
 - (f) problem of power supply?
 - (g) non-availability of essential machine spares?
 - (h) poor quality of raw materials?
 - (i) other causes like, fire, earthquake?
 - (j) lack of proper quality control?
- (vi) Can the work methods be improved?
- (vii) Are the machines utilised to their capacity?
- (viii) Can the work be further mechanised with advantage?

Personnel is perhaps the most important factor in performance evaluation. Unless the organisation has a sound personnel policy consistent with its requirements, the facilities, materials and equipment that are available in the organisation may not be utilised properly to obtain optimum performance. The operational auditor in his appraisal of personnel can make use of the quantitative data readily available to him like number of employees, personnel turnover, total regular and overtime hours worked ratio of direct employees to indirect employees and so on. He should also take into account the undernoted broad aspects involving personnel:

- (i) Whether the organisation has properly qualified and experienced personnel for the various levels of work?
- (ii) Is the number of people employed at various work centres adequate, excessive or inadequate?
- (iii) Does the organisation provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?
- (iii) Is the organisation unable to obtain staff possessing requisite qualifications?
- (iv) If yes, what are the reasons:
 - (a) Low wages?
 - (b) Bad working conditions?
 - (c) Management attitude?
 - (d) Status of the organisation in the industry?
- (v) Is the rate of staff turnover high? If yes, what are the causes?
- (vi) Is the ratio of overtime to regular man-hours excessive or normal?
- (vii) Why is the need for overtime?
- (viii) If the ratio of overtime is high, what is being done to reduce it?

Work load measurement can be another significant area where operational auditor can be of use because of ready availability of quantitative data. There can be measures like volume or quantity of work handled and/or performed volume of new work, backlog of work, etc. The propositions that would usually arise in this area may be as follows:

- (i) Is there any backlog of work? If yes, is it due to increasing volume of new work on the existing work itself is heavy by reference to the staff and facilities available?
- (ii) Is the new work volume increasing or decreasing?
- (iii) How to meet the increasing work load? Would it be worthwhile to employ more staff or get the work done by overtime?
- (iv) Is the current work done in time?
- (v) Is the backlog increasing or decreasing?

Quality of work is a matter which is not directly amenable to operational audit scrutiny. Nevertheless, it is an important aspect of performance of an organisation. Therefore, some quantitative measures are often devised to judge the quality of work. These can be number of customers' complaints, rejections by quality control department, number of workers' grievances, number of errors in invoicing or recording transactions, quantity of scrap and wastages, etc. The auditor may comprehend the quality aspect by reference to certain objective questions like:

- (i) Is the present work quality satisfactory in so far as customers, suppliers, bankers, workers and the quality standards followed are concerned?

19.40 Advanced Auditing and Professional Ethics

- (ii) If not, what are the factors that account for unsatisfactory quality? Is it the workload, lack of equipment, bad quality of raw materials or other materials in use, unsatisfactory working conditions giving rise to workers' grievances or the methods?
- (iii) Is the quality of work getting better or worse?
- (iv) Is the quality of work responsive to training imparted to workers?
- (v) How can the quality be improved whether by changing the work methods or boosting the workers' morale by adding more technical facilities, by improving supervision or by enforcing stricter control on quality of materials that go into the work?

Cost is perhaps the most cogent indicator of performance. Costs are classified and recorded for a proper assimilation of their implications on performance. The operational auditor may be concerned with such matters as:

- (i) Is the cost break-up realistic so as to serve as a basis for performance evaluation?
- (ii) Are the costs collected under various heads and sub-heads showing an increasing trend per unit of output?
- (iii) Do costs conform to forecasts? If not on what count?
- (iv) Are the costs of various departments or divisions justified?
- (v) Are all the activities necessary?
- (vi) Would it be better if the company buys some of the components or output from outside instead of producing them?
- (vii) Are the people cost conscious?

Though controversial, a school of thought holds that operational auditing can be stretched to evaluate management objectives and plans. This view stems from the fact that everything in an organisation is the product of basic plans and objectives set by the management. If the management policy favours installation of controls or specifies the extent of controls whether satisfactory or not, controls would have to stay within the policy frame. Therefore, the basic thing that should be evaluated is management policies, plans and objectives. However, it should be noted that there exists considerable opposition to the aforesaid view. The other viewpoint holds that operational auditing by its nature should be confined to operations and related controls. The aim of operational auditing is to appraise operations and controls and their adherence to prescribed or laid-down policies and not to go into the question of appropriateness of plans and objectives. However, the operational auditor may look into the aspects like whether objectives are clearly spelt out and properly communicated to the personnel responsible for implementation and whether the personnel have understood the objectives in the sense meant by the management. Also, he can take note of any apparent conflict in the objectives for its effect on operations.

Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. Therefore, this is also another important area for appraisal by the operational auditor. In evaluating organisational structure,

the aspects that may be considered by the operational auditor may be as follows:

- (i) Is the organisational structure in conformity with management objectives?
- (ii) Whether the organisational structure is drawn up on the basis of matching of responsibility and authority?
- (iii) Whether the line of responsibility from the top to the bottom is clearly discernible from the structure?
- (iv) Whether the delegation of responsibility and authority at each stage is clear and overlapping are avoided?

19.9 Review of Systems and Procedures

19.9.1 Systems

The word 'system' is commonly defined as "a set of objects, together with relationships between the objects and their attributes, connected or related to each other and to their environment in such a manner as to form an entire or integral whole." The definition can be better understood with reference to a complex biological system of human beings which consists of various sub-systems, e.g. nervous system, digestive system, respiratory system, blood circulation system, reproductive system, etc. Each sub-system in turn, may be treated as a complete system in itself. For instance, digestive system consists of various organs, say stomach, esophagus, intestines, etc. which are interdependent and interrelated, so that failure of any part will lead to failure of the digestive system. Thus, the essence of a system lies in the inter-relationship and inter-dependence of various parts and processes. Unrelated and independent parts can never constitute a system. Similarly, it can be said that a business organisation also does not operate in a vacuum. Its various operations - manufacturing, purchasing, marketing, accounting and finance, research and development, personnel - comprise a system. All of these functional departments are combined into a complex unified, whole. The overall system i.e. a business organisation is made up of many interacting and related sub-systems, e.g. the various functional departments. These operation have to take into account and needs and operating modes of all the people, enterprises and governments that make up the environments in which it operates. To accomplish an objective by means of a system entails three main steps:

1. Design a system to achieve the main objectives.
2. Operate the system.
3. Check that the system is operating and producing as intended by its design, i.e. that the stated objective is being achieved.

19.9.2 Procedures

Procedures are the means by which policies are implemented. Most often, procedures entail the use of documents in accordance with precise instructions or methods to be used. At lower levels

19.42 Advanced Auditing and Professional Ethics

in an organisation, formalised and authorised procedures become more numerous and of specific nature because of following factors:

1. There exists economic advantage of specifying precise uniform action to be taken by a large number of people and for repetitive jobs.
2. The need for more precise control over employees' activities which can only be achieved if there are detailed prescriptions of how things are to be done.
3. The element of discretion has to be reduced as far as possible.

Standard procedures go a long way towards making sure that pertinent information flows to the people who need it and that each person understands what he is to do with it. In addition, standard procedures, when expressive of policy guidelines established by management, facilitate control of business operations. The purpose of establishing procedures is also to ensure consistent interpretation of policies. That eliminates the need to make the same decisions over and over and leaves more time for creative planning, thoughtful analysis and productive effort.

19.9.3 Review of Systems and Procedures

The purpose of systems and procedures is to help management in the planning and accomplishment of organisational purpose, in communicating their requirements, and in assisting the personnel in carrying out the requirements. The review of systems and procedures is to improve the methods, to get away from the old ways and traditional routines and to reduce the cost in completing and processing the paper work - eliminating waste, duplication and inefficiencies. In reviewing any system or procedure, the management auditor must concern himself with its purpose as well as its design and then he must decide on its merits as the best serving the interests of the enterprise. A poor system or procedure may prevent the carrying out of the policy for which it was intended. A system may have outgrown its usefulness. The end result of a system or a procedure may be loose and may require improvement. In the study of the systems and procedural functions, the auditor should ask himself:

1. Is the function properly located in the organisation?
2. Do the staff personnel have the necessary training and experience to perform the work?
3. Has a definite programme been established and has been taken for its attentive accomplishment?
4. Is productivity satisfactory?

The evaluation of a system or a procedure actually includes three separate considerations. First, is the system or procedure meeting all of the current requirements? Second, is it operating effectively? And third, what is the degree of effectiveness? To determine whether system or procedure is meeting current requirements, the following among other things, should be considered:

1. Is the system or procedure designed to promote achievement of the company's objectives, and is it accomplished effectively?
2. Does the system or procedure operate within the framework of the organisational structure?
3. Does the system or procedure adequately provide methods of control in order to obtain maximum performance with the least expenditure of time and effort?
4. Do the routines designated in the system or procedures indicate performance in logical sequence?
5. Does the system or procedure provide the means for effective coordination between one department and another?
6. Have all required functions been established?
7. Has the necessary authority been designated to carry out responsibilities?
8. Can any changes be made to improve effectiveness?

The important thing is to make sure that the system or procedure is designed to meet the desired results. One must determine what is actually done, as well as where, how, when, and by whom. Each individual step in the process must be studied and its effectiveness considered. At the same time, one must be constantly alert for possible improvements. While it may be difficult to determine a precise measurement of how effectively a system or procedure operates, the degree of effectiveness can be somewhat ascertained by checking on the activities from the standpoint of speed, accuracy and orderly flow of paper work. Do bottlenecks and delays occur from time to time the schedules, reports, or end results promptly completed and furnished on time? Are operations proceeding well or better than expected? What is the relationship between the volume of work and the number of employees performing the work, and how does it compare from month to month? The auditor must always be on the alert for possible defects and irregularities. He must check the activities with the instructions, to see if the instructions are properly complied with. All deviations must be called to the attention of the supervisor who is responsible for the proper adherence to instructions, and necessary corrective action taken. On occasions, due to some unusual circumstances, the auditor may find that good judgement often dictates some deviation from an instruction possibly to better achieve a desired objective. Management must be constantly alerted to the importance of systems and procedural function as an element of good organisation and management.

Differences between Financial and Operational Auditing - The major differences between financial and operational auditing can be described as follows:

- (i) **Purpose** - The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

19.44 Advanced Auditing and Professional Ethics

(ii) **Area** - Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.

(iii) **Reporting** -The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However the operational audit report is primarily for the management.

(iv) **End Task** - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also.

19.10 Management Audit Questionnaire

A management audit questionnaire is an important tool for conducting the management audit. It is through these questionnaires that the auditors make an inquiry into important facts by measuring current performance. Such questionnaires aim at a comprehensive and constructive examination of an organisation's management and its assigned tasks. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation. It includes a review of how well or badly the management functions of planning, organising, directing and controlling are being performed. The questionnaire provides a means for evaluating an organisation's ongoing operations by examining its major functional areas. There are three possible answers to the management audit questions: "Yes", "No" and "N.A.", (not applicable). Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. The management audit questionnaire does not give answers, but simply asks questions. If all questions are answered with a 'yes', operations are proceeding as desired. On the other hand, if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A. (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesis those elements that are causing organisational difficulties and deficiencies.

APPENDIX

The following Standards on Internal Audit are recommendatory in nature. The Standards shall become mandatory from such date as notified by the council:

- SIA 1 : Planning an Internal Audit
- SIA 2 : Basic Principles Governing Internal Audit
- SIA 3 : Documentation.
- SIA 4 : Reporting
- SIA 5 : Sampling
- SIA 6 : Analytical Procedures
- SIA 7 : Quality Assurance in Internal Audit
- SIA 8 : Terms of Internal Audit Engagement.
- SIA 9 : Communication with Management
- SIA 10 : Internal Audit Evidence
- SIA 11 : Consideration of Fraud in an Internal Audit.
- SIA 12 : Internal Control Evaluation
- SIA 13 : Enterprise Risk Management
- SIA 14 : Internal Audit in an Information Technology Environment
- SIA 15 : Knowledge of the Entity and its Environment.
- SIA 16 : Using the Work of an Expert.
- SIA 17 : Consideration of Laws and Regulations in an Internal Audit.
- SIA 18 : Related Parties

Investigation and Due Diligence

20.1 Introduction

The term investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. In other words, investigation means inquiry into facts". Professional accountants are often required to investigate the accounts or the related matters and records of the enterprise. The term investigation may be defined as an examination of books and records preliminary to financing or for any other specified purpose, sometimes differing in scope from the ordinary audit. Thus, investigation covers areas of financing decisions, investment decisions, fraud or profitability determination or cost determination etc.

20.2 Audit versus Investigation



Investigation differs substantially from an audit assignment. Audit aims at collection of sufficient appropriate audit evidence to enable the auditor to form a judgement and express an opinion on the financial statements or other data under examination. An investigation, on

the other hand, requires special in-depth examination of the particular records or transaction with the objective of establishing a part or happening or assessing a particular situation. The scope of audit is broad based and general in nature whereas investigation is narrow and specific.

The difference is tabulated below:

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute	The scope of audit is wide and in case of statutory

	or it may be non- statutory.	audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
(viii) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

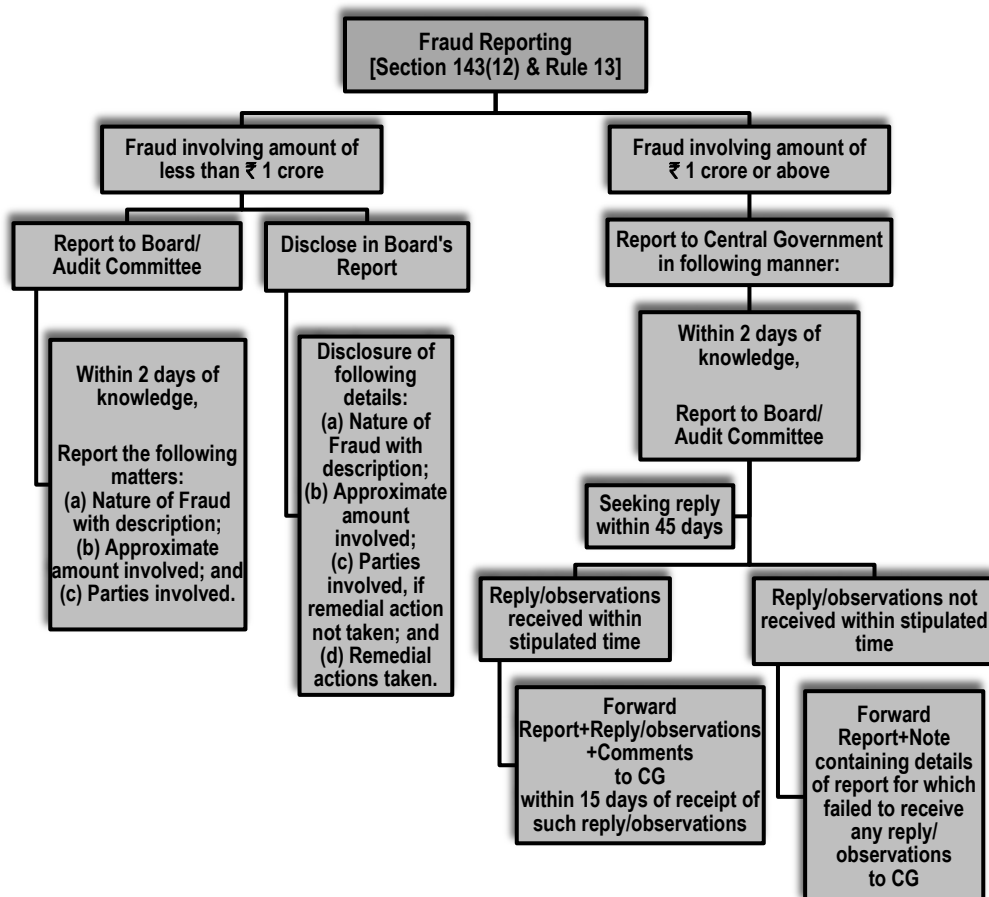
The approach to an investigation is different from that followed in an audit. An investigation involves a more detailed examination of the selected areas than what is required in an audit. An investigation seeks substantive and in some case even conclusive evidence as compared to audit which mainly relies on persuasive evidence.

An investigator does not accept a stated fact as correct until it is substantiated. An auditor, in the absence of suspicious circumstances, relies on stated facts or figures. An auditor has to see whether the method of valuation and other accounting policies have been properly made in the financial statements or not. An investigator, however, is not by accounting conventions, policies and disclosure requirements. An auditor does not suspect unless circumstances are there to arouse suspicion, while an investigator approaches the work with a frame of mind to suspect, verify and satisfy.

The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor. However, sub section 12 of section 143 of the Companies Act, 2013 deals with the

20.3 Advanced Auditing and Professional Ethics

fraud reporting requirements which are discussed below:



- I. Reporting to the Central Government- As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.***

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (a) *the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;*
 - (b) *on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;*
 - (c) *in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;*
 - (d) *the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;*
 - (e) *the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and*
 - (f) *the report shall be in the form of a statement as specified in Form ADT-4.*
- II. Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.**
- In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:*
- (a) *Nature of Fraud with description;*
 - (b) *Approximate amount involved; and*
 - (c) *Parties involved.*
- III. Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such**

20.5 Advanced Auditing and Professional Ethics

frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

- (a) Nature of Fraud with description;*
- (b) Approximate Amount involved;*
- (c) Parties involved, if remedial action not taken; and*
- (d) Remedial actions taken.*

No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provision of this rule shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees)

Case Study

Intelligent Ltd. entered into an agreement with Mr. Intellectual on 15th March, 2016, whereby it agreed to pay him ₹ 2 lakhs per month as retainership fee for consultation in IT department. However, no amount was actually paid and ₹ 24 lakhs was provided in the Statement of Profit and Loss for the year ending on March 31st, 2016.

Management of the company uttered that need-based consultation was obtained throughout the year. However, on investigation, no documentary or other evidence of receipt of such service was found. As the auditor of Innocent Ltd., what would be your approach?

Provisions and Explanation: As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

In the given case, Intelligent Ltd. has entered into an agreement with Mr. Intellectual, at year-end, for consultation in IT department. It also charged yearly fee of ₹ 24 lakhs in the Statement of Profit and Loss, however, no documentary or other evidence of receipt of such service was found, on investigation. It is clear that company has passed fictitious journal entries, near year-end, to manipulate the operating results.

Accordingly, the auditor would adopt the approach which will be based on the result of misstatement on the basis of such fictitious journal entry, i.e. if, as a result of a misstatement

resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities; or the auditor may consider for appropriateness of withdrawal from such engagement, where withdrawal from the engagement is legally permitted.

In addition, the auditor is required to report according to section 143(12) of the Companies Act, 2013. As per Section 143(12), if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the audit committee within 2 days of his knowledge (as amount involved is less than one crore rupees) and after following the prescribed procedure such as reporting on : Nature of Fraud with description; (ii) Approximate amount involved; and (iii) Parties involved etc.

20.3 Steps in Investigation

As investigation involves a variety of situations, it is not possible to lay down any standardised procedure. However, usually, an investigation requires the following steps in order of sequence:

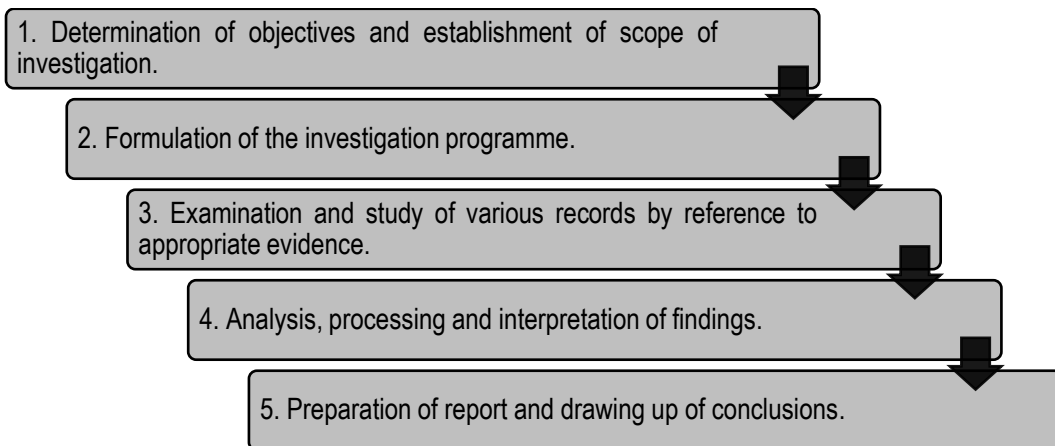


Diagram showing Sequence of Steps for Investigation

Now let us study each of these steps in detail.

20.3.1 Determination of objectives and establishment of scope of investigation

At the stage of acceptance of the assignment, the investigator should be absolutely clear about what is sought to be achieved by the investigation. If instructions from the client leave matters vague and non-specific, it would be proper for the investigator to have the matters discussed and obtain clearly written instructions covering the object and the scope of investigations and the issues incidental thereto.

20.7 Advanced Auditing and Professional Ethics

The period which the investigation should cover should be clearly specified. The results of investigation are often seriously affected owing to change in circumstances which have occurred since it was contemplated, e.g., devaluation, import restrictions, starting of a new division, etc. Therefore, the purpose of the investigation should be borne in mind while determining the period which an investigation should cover.

20.3.2 Formulation of the investigation programme

It is not possible to draw up one programme to serve different types of investigations which a professional accountant is called upon to carry out, for their scope and content have to be determined on a consideration of circumstances peculiar to each business or situation. The investigation programme should be drawn up having regard to the nature of the business, the structure of business, the instructions from the client embodying the objectives, the consequent scope and depth and the necessity to extend the investigation into books and records belonging to others. The programme should also be flexible so that knowledge gained with the progress of work can be used to extend, reduce or modify the extent and areas of checking.

In programming the verification, the investigator should concentrate on areas considered relevant rather than to undertake a wide-ranging verification. For example, in an investigation on suspected payment of wages to ghost workers, the investigator should scan the areas having a bearing on the determination of wages and payments thereof. He should concentrate on time and job cards, appointment and termination of workers, attendance records, internal controls, internal checks, and preparation of wage sheets, withdrawal of money from bank for payment of wages and the actual disbursement of wages. A conscious effort in investigation programming should be devoted to localise the enquiry into the relevant areas and, for that purpose, the initial wider base of inquiry should be gradually narrowed and fixed at a level that is meaningful. Matters not found to have a bearing on the subject matter of investigation should be gradually and progressively eliminated. This procedure alone will enable an in-depth examination of the matters relevant to the investigation.

20.3.3 Collection of Evidence

Through examination, the investigator would be gathering relevant evidence connected with the matters to be investigated. In the course of examination of the documents and records, the investigator may require to obtain oral explanations from various personnel of the concerned business. In case his client is a person external to the business, it may be necessary for the investigator to get the matter formally agreed to by the business through the client. The investigator should look for the most convincing evidence; he should seek and examine all the available evidence and by a process of elimination and corroboration, should endeavour to reach at the truth of the matter. He, unlike the auditor, is not to restrict himself to *prima facie* evidence ordinarily available. He should examine it and if circumstances demand should try to obtain evidence that may have to be specifically procured. For example, in the matter of valuation of land, he should definitely have regard to the available evidence as per records of the business and records of any bid received for the land. In addition, he should have regard to the prices at which land was sold or purchased in the neighbourhood around the same time.

This may require him to obtain evidence even by going to the land registration office. He may also call for the report of experts in land valuation.

20.3.4 Analysis and Interpretation of Findings

Careful analysis and correlation of facts and figures will be necessary before the investigator can reach his conclusion. The conclusion should be well reasoned and backed by established facts and data. He must analyse the data objectively on the basis of evidence gathered by him and should not draw conclusions according to pre-conceived notions. While interpreting the figures, the investigator must keep in mind various factors e.g. the political and economic considerations, competition faced by the business, historical pattern of the data, nature of the business, etc.

20.3.5 Reporting of findings

Like all other work of an accountant, an investigation results in a report. It is submitted and addressed to the party at whose instance the investigation has been carried out. The nature of the report is governed mainly by two factors. First, the instructions given by the client as regards the special aspects of the business which are required to be investigated; and second, the findings of the investigating accountant. The important issues to be kept in mind by the investigator while preparing his report are as follows:

- (i) The report should not contain anything which is not relevant either to highlight the nature of the investigation or the final outcome thereof.
- (ii) Every word or expression used should be properly considered so that the possibility of arriving at a different meaning or interpretation other than the one intended by the investigator can be minimized.
- (iii) Relevant facts and conclusions should be properly linked.
- (iv) Bases and assumptions made should be explicitly stated. Reasonableness of the bases and assumptions made should be well examined and care should be taken to see that none of the bases and assumptions can be considered to be in conflict with the objective of the investigation. For example, in an investigation into over-stocking of raw materials, inventories and spares etc. it should not be assumed that the ordering levels indicated on bin cards provide fair guidance about acquisition of further materials. Also, since investigation is a fact finding assignment, assumptions should be made only when it is unavoidably necessary.
- (v) The report should clearly spell out the nature and objective of the assignment accepted its scope and limitations, if any.
- (vi) The report should be made in paragraph form with headings for the paragraphs. Any detailed data and figures supporting any finding may be given in Annexures.
- (vii) The report should also state restrictions or limitations, if any, imposed on the instructions given by the client. Preferably the reasons for placing such restrictions and their impact on the final result should also be stated.
- (viii) The opinion of the investigator should appear in the final paragraph of the report.

20.9 Advanced Auditing and Professional Ethics

Due to non-availability of standardised procedure and lack of professional guidance, investigation calls for extreme care, caution and circumspection on the part of the investigator in exercising his judgement and discretion. Investigation often has a characteristic of very intimate and direct involvement of parties whose interest may be affected. Therefore, unlike auditing, chances of one or the other of the parties challenging the finding of the investigation are far greater.

20.4 Special Issues in Investigations

Investigations broadly range between two extremes; on the one hand there are those in respect of which complete accounts, documents, records and other information are available, and on the other, those in respect of which little information, besides published accounts and statistical data, is available. Then again, investigation may cover the whole of accounting or may relate to only a part or parts of accounting as may be specified. Some more issues often arise in investigation. They are stated below:

(a) Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification - The answer to this question depends on the exact circumstances of the case under investigation. If the investigator has to establish the amount of cash defalcated by the cashier, he has probably no option but to carefully examine all the cash vouchers and related transactions. On the other hand, if he is to arrive at the profitability of a concern, he may verify constituent transactions on a selective basis taking extreme care to see that no material transaction that affects profit has remained concealed from his eyes. In investigation, it is always safer to go by statistically recognised sampling methods than to depend on the so-called "test checks" where circumstances permit selective verification.

(b) Whether the investigator can put reliance on the already audited statement of account - Here also no dogmatic views are possible. If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh. It was held in the case of *Short & Compton v. Brackert (1904)* that an accountant, when making an investigation for an incoming partner, was entitled to assume that the figures appearing in the books were correct. In another case, *Mead v. Ball Baker & Co. (1911)*, it was held that an accountant, when acting as an adviser to a proposed investor in a limited company, was not expected to check errors in stock sheets and the omission of liabilities. These cases were decided long time ago. Therefore, much reliance cannot be placed on them. It is, therefore, desirable for the investigator to ascertain from the client, in advance, in writing, whether the audited statements of account produced to him should be taken as correct.

If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties settled in the famous Hedley Byrne's case. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

(c) Whether an investigator necessarily requires assistance of expert - Often an investigator may feel the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation. It would be therefore, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts; at the beginning it and he should settle the question of costs for obtaining the views and other related implications.

(d) Investigation out of disputes and conflicting claims - Cases for investigation sometimes arise out of disputes and conflicting claims. It is needless to emphasise that the investigator should remain above disputes or conflicting claims and be alert to the possibilities of the information or documents made available to him to be prejudiced. Even the client, overtly or covertly, may try to influence his reports. A seller of a business or controlling shares may request him to see that he gets the most favourable price. Similarly, if he is appointed by the buyer, he may be requested to deliberately depress the value. The investigator should keep him scrupulously professional and should keep the interest of all the involved parties in view. This is a challenging task and probably no other professional work offers this much of challenge. This work is exciting too and requires not only the best of skill but of a high degree of maturity and experience.

(e) Basis of opinion of an investor- The investigator should refrain from issuing speculative opinion. He should confine his opinion to the established facts and nothing more. If the facts, as conveyed through the books, records, papers and other evidence, are not capable of being properly established, he should not express an opinion or, if at all he expresses any opinion, he should qualify the opinion appropriately. This problem may particularly arise in cases where incomplete books and records are produced for investigation.

(f) Whether an investigator can make futuristic statements - The investigator should refuse to be futuristic. He may assume that the established trend in the business will continue in the near future, in the absence of any contrary evidence, in arriving at the present value of a business. He, however, should not project the trend into any future years to establish a value.

(g) Whether to retain working papers or not - Another important precaution is that the investigating accountant should retain, on his files full notes of the work carried out, copies of schedules and all working papers, record of conversations and the like. Also the working papers should link up the figures shown by the books of business with the final figures produced by the accountant. In the absence thereof, he would not be able to explain the figures when he is called upon to give evidence in a court of law to support his figures; for

20.11 Advanced Auditing and Professional Ethics

quite often the conclusions of the accountant are challenged by parties whose interest is adversely affected by his findings, for example, when the value of shares of a company taken over by the Government has been determined by him. This will also be of immense help to the investigator in correlating facts and events and later in drafting the report.

20.5 Special Aspects in Connection with Business Investigations

We discuss below the factors to be considered by a professional accountant while carrying out the investigation for attaining satisfactory results:

(a) Studying the overall picture - In such a business investigation, it is of utmost importance first to have an overall picture of the position of the business which is being investigated before the details are gone into. This is because figures are only symbols; and it is impossible to interpret them intelligently without knowledge of the background in which they have emerged. For instance, for investigating the accounts of a group of companies, it would not be possible to know the manner in which the profits had emerged in the past unless a chart is prepared, showing the relationship of different companies comprising the group; whether as subsidiaries or not, the nature of transactions entered into by one unit in the group with another or others and the terms on which this has been done. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally. If the business is labour - intensive, its future profitability would be dependent on availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers also must be examined. Apart from these preliminary enquiries, the investigating accountant should study:

- (i) the character of management;
- (ii) the economic and political forces to which the business is subject; and
- (iii) the position it enjoys in trade.

At times, political or economic factors also may affect the fortunes of a business; for example, labour disturbances, changes in government policies in the matter of levy of excise and custom duties, imports, etc. It is, therefore necessary that the impact of all these factors should be studied and their effect on the business judged on a consideration of the profits in the past. For studying the economic and financial position of the business, the following should be considered:

- (i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?
- (ii) What will be the trend of the sales and profits in the future? Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

- (iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

For finding answers to all these questions, the Statement of Profit and Loss and the Balance Sheets of the concern for the past several years should be examined.

(b) Statement of Profit and Loss - To study the Statement of Profit and Loss of a concern, it is necessary to consider each item, included therein, in relation to the corresponding items in the Statement of Profit and Loss of the previous years. It is therefore, necessary that a summary, in a columnar form, should be prepared of the balances included in the Statement of Profit and Loss of the business for a period, say of 5 to 7 years.

In the foregoing summary, in the place of figures of opening and closing inventories, the figures of inventory consumed in different years should be entered. It should also be verified that the inventories have been valued on a consistent basis throughout the period under review. If there has been a change, the values of inventories should be adjusted. Further, in the summary, the gross profit ratios and the ratios showing the relationship between various items of expenses and sales should be entered. The trend of these ratios should be examined and, if there is a wide divergence in them, an explanation for the same should be sought. In the preparation of the summary attention should also be paid to the following matters:

Turnover - The figures of sales should be broken down between the various products sold to show variations in turnover of individual products from year to year. In this way, it would be possible to find out the products the sales of which have been increasing and those the sales of which have been falling. Further, by reference to the list of customers, in the Order Books, it should be ascertained whether the business has a very large turnover with a few customers or a small turnover with several customers. The Order Books should also be examined to find out if fictitious sales have been entered in any year to boost up profits. If so, the figures of sales of the year or years should be adjusted. If the business consists of activities which are dissimilar in operation, like manufacturing and agency, then apart from splitting the income between the two sources, expenses should also be apportioned between them to separately arrive at the figures of profit from each of the activities.

Wage structure - The method of computing wages and the rates of wages should be examined. On occasions a business may have to pay higher wages than those prevailing in other business in the same neighbourhood in pursuance of an industrial award. Another factor which is important to consider in this connection is the relationship of the business with its workers. A business which has suffered several industrial disputes, strikes, etc. and has had its working interrupted by them frequently cannot be expected to prosper unless a proper settlement is reached with workers' unions.

Depreciation - The charge on account of depreciation and maintenance of machinery and other assets included in the accounts of different years should be compared to verify that depreciation has been provided from year to year on a consistent basis and that it is adequate. Also, the necessary adjustment in the depreciation charge should be made if it is the practice of the company to write off the assets on a renewal basis. Further, if assets have been revalued, it should be confirmed that depreciation on the increased valuation has been adjusted. Generally, with age, the cost of maintenance of assets should increase. If it has not,

20.13 Advanced Auditing and Professional Ethics

the reason thereof should be ascertained. In case of leasehold property, it should be ascertained whether an adequate provision has been made for the dilapidation charge which may be payable at the end of the lease. Further, compliance of relevant AS should also be verified.

Managerial Remuneration - It should be verified that the remuneration payable to various members of managerial personnel is not excessive in relation to the profits of the business after taking into account the time devoted by each of them. However, it could also be that no or only a nominal remuneration has been charged in the accounts. In either case, an adjustment should be made to arrive at true profitability of the concern. Further, in case of company, requirement of relevant section of Companies Act, 2013 is to be seen. It has to be assured that calculation of profit for arriving at the remuneration is correct.

Exceptional and non-recurring items - It is customary to adjust exceptional items in the summary of Statement of Profit and Loss in order that they may not obscure the trend of the profits. In the matter of non-recurring items, it is necessary to remember that adjustments are to be made in respect of exceptional items which do not recur from year to year or can be considered exceptional having regard to their materiality or periodicity. In this connection, it is worthwhile to examine the income tax assessment orders of the business to find out the items which have been treated as revenue but have been regarded by the taxing authority as inadmissible. Where the effect of these has been abnormal on the tax paid by the company from year to year, suitable adjustments should be made in the figures of taxes paid, as well as in the assets amounts. Likewise, adjustments should be made in respect of exceptional profits and losses.

Repairs and maintenance - It is one of the recurring expenses of a business. Occasionally it is noticed that this expenditure is unduly heavy in some of the years, while quite low in some others. Generally, companies, as a matter of routine undertake major repairs, overhauls and maintenance programme at an interval of 3 or 4 years while running repairs and maintenance continue in the usual manner which gives rise to fluctuating charges in the accounts unless periodic major expenses are treated as deferred expenditure. Besides, due to wrong allocation of expenses between capital and revenue, repair charges may appear to be heavy or low. If fluctuating and abnormal charges for repairs is noticed, it would be the duty of the investigating accountant to scrutinise this head thoroughly to establish correct and normal charge for repairs.

Unusual year - A company's record of profitability may show a trend of increasing or decreasing profit or loss or it may be highly erratic and fluctuating. Where a definite trend is discernible, the job of the investigating accountant is somewhat simplified. He can adopt recent years' record of profitability as the basis for estimating future maintainable profit having regard to the inflationary state in the economy. But if the same is fluctuating, there would be more demand on judgement of the accountant in selecting the period to be covered for estimation of profitability. In such cases it may even be necessary to take into consideration

results of past 9 to 10 years with a view to iron out the fluctuation. If, however, it is noticed that results of one or more years under scrutiny were materially vitiated by exceptional factors like a long term industrial dispute, natural calamities, fire, war, ravage etc., the investigating accountant should eliminate such year / years from consideration altogether since they do not reflect the results obtained through normal business.

(c) Balance Sheet

Fixed Assets - Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap.

In addition, from a study of the maintenance expenses incurred from year to year, it should be judged whether the assets have been properly maintained. If not, it might be necessary to incur heavy expenditure on repairs to put them in a proper working order. In such a case, an allowance for this factor should be made in the value of assets. More particularly, it should be seen that if assets have been revalued, the increased depreciation charge has been adjusted against profit. Para 10 of the Guidance Note on 'Treatment of Reserve created on Revaluation of Fixed Assets' states that when a company has created revaluation reserve by revaluation of fixed assets and the company has charged the additional depreciation to Statement of Profit and Loss, it is possible to transfer an amount equivalent to accumulated additional depreciation from the revaluation reserve to Statement of Profit and Loss or General Reserve as the case may be. Further, investigator has to assure whether assets whose recoverable amount is less than carrying amount are impaired and requirement of AS 28, "Impairment of Asset", has been complied.

Investments - Investments should be broadly classified into long term investments and current investments. A current investment is by its nature readily realisable and is intended to be held for not more than one year. All other investments are long term investments. Current investments are valued on the basis of lower of cost and fair value determined either on an individual investment basis or by category of investment but not on an overall basis. Long-term investments are usually carried at cost. However, when there is a permanent decline in the value of long-term investments, the carrying amount should be reduced to recognise the decline. The carrying amount of long term investments is determined on an individual investment basis. Interest, dividends and rentals receivable in connection with investment are generally regarded as income. However in some cases, such receipts represent recovery of cost and should therefore be reduced from, the cost of investment (e.g. dividend out of pre-acquisition profits).

Inventories-It should be seen that inventories have been valued consistently and that the basis of valuation was such that the value placed on inventories did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow moving inventories.

20.15 Advanced Auditing and Professional Ethics

Trade Receivables - In assessing their value, the following should be taken into account:

- (i) Whether bad debts have been adjusted in the years in which the relevant sales took place instead of in the year in which they have been written off. Normally, such an adjustment should be made but not when debts have had to be written off on account of a slump or a fall in international prices, during a period subsequent to the period in which sales had taken place.
- (ii) The length of the credit period allowed throughout the period under investigation, to determine whether it has been necessary to increase continually the credit period in order to effect the sales. If it has been so, it would indicate that the demand for the goods manufactured by the concern in the market has been diminishing gradually.
- (iii) Debts should be classified according to their age. This would disclose the character of the parties with whom the company trades and the amount of working capital that will be necessarily blocked on this account in the course of business.

Other liquid assets - It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets - On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. These may come from all sections of assets. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time. The company may hold large cash and bank balances, not warranted by the need of the business. Then again, there may be instances of obsolete and slow moving inventories of large value in the accounts of the company. It would be the duty of the investigating accountant to eliminate these idle assets, if any, after proper identification from the net worth of the business. However, proper value of these assets may be separately added to the value of the business.

Liabilities - The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation - Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Capital - In this regard, it is necessary to ascertain:

- (i) Whether the capital is well balanced. This would not be the case if the amount of debentures and preference share capital are disproportionately large as compared to the equity capital, for this would be a handicap to the company in raising further equity capital, on favourable terms for financing the business or to pay off capital commitment. Further, when the capital is highly geared, it would affect the value of the equity capital;
- (ii) That the amount of capital is reasonable compared to the value of fixed assets and the amount of working capital required. The terms associated with the issue of the capital should also be studied; restriction on transferability of shares usually depresses the value of share and of the business.

(d) Interpretation of figures -

Fixed Assets - The amount of capital expenditure which would be necessary in the future for the continuation of the business, in its existing stage, should be assessed having regard to the under-mentioned factors:

- (i) the amount required for the replacement of assets when these would become worn out or obsolete;
- (ii) the expenditure which will be necessary to replace obsolete machinery by more sophisticated machinery for manufacturing different types of goods for which there is demand.

Turnover - In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

- (i) **Trend:** Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
- (ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.
- (iii) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?
- (iv) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Working Capital - In making assessment of the working capital requirements in the future, the following matters should be taken into account:

- (i) Has the ratio of inventory to turnover been increasing and if so, is it a continuing or only a temporary trend?

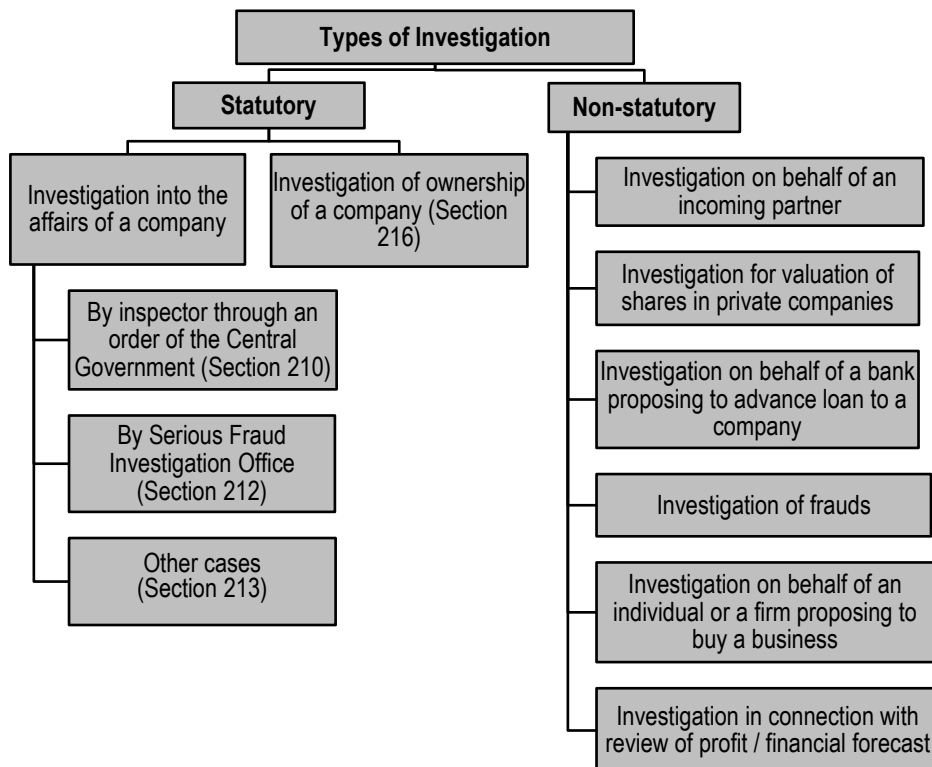
20.17 Advanced Auditing and Professional Ethics

- (ii) Are the trade payables being paid promptly or is there a backlog which will have to be dealt with?
- (iii) What will be the effect on inventory, trade receivables and trade payables, if the turnover is increased or if new products are introduced?

Estimating future maintainable profits - Fluctuations in profits during the years under review should be examined after adjusting the profits for extraneous factors, if any, that had given rise to fluctuations to determine whether the factors responsible for the fluctuations were temporary or was likely to recur in future. A statement should be prepared showing separately the profits after depreciation earned in each of the years during the period under review, after making adjustments therein, if considered necessary, as regards factors which have been responsible for any extraordinary increase in profits. If the percentage of profits before taxation to capital has been stable or has been increasing, it would indicate that the business would continue to earn the same rate of profit as it has done in the past. If, on the other hand, the percentage has been falling, and there is no evidence that the factors responsible therefore have ceased to operate, investment of further capital in the business would not be commercially advisable.

20.6 Types of Investigation

The different types of investigation that a chartered accountant is usually called upon to carry out are given hereunder:



Statutory - By an inspector under Sections 210, 212, 213 and 216 of the Companies Act, 2013.

Non-statutory - These are listed as under:

- (a) Investigation on behalf of an incoming partner.
- (b) Investigation for valuation of shares in private companies.
- (c) Investigation on behalf of a bank proposing to advance loan to a company.
- (d) Investigation of frauds.
- (e) Investigation on behalf of an individual or a firm proposing to buy a business.
- (f) Investigation in connection with review of profit/financial forecast.

20.6.1 Investigation under the Companies Act, 2013

Investigation under the Companies Act, 2013 may broadly be classified into:

- (A) Investigation into the affairs of a company; and
- (B) Investigation of ownership of a company.

(A) Investigation into the affairs of a company: This may further be divided into three parts:

- (1) Investigation into the affairs of a company by inspector through an order of the Central Government as envisaged under Section 210.
- (2) Investigation into the affairs of a company by Serious Fraud Investigation Office as prescribed under Section 212.
- (3) Investigation into the affairs of a company in other cases as provided under Section 213.

(1) Investigation into the affairs of a company as envisaged under Section 210: Where the Central Government is of the opinion, that it is necessary to investigate into the affairs of a company-

- (a) on the receipt of a report of the Registrar or inspector;
- (b) on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated; or
- (c) in public interest,

it may order an investigation into the affairs of the company.

Further, where an order is passed by a court; or the Tribunal requiring investigation, the Central Government shall order an investigation into the affairs of that company.

For the above purposes, the Central Government would appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

20.19 Advanced Auditing and Professional Ethics

(2) Investigation into the affairs of a company by Serious Fraud Investigation Office under Section 212: The Central Government may, by an order, assign the investigation, into the affairs of the company, to the Serious Fraud Investigation Office, when it considers necessary to investigate into the affairs of the company, on receipt of a report of the Registrar or inspector; or on intimation of a special resolution passed by a company; or in public interest; or on request from the Department of the Central Government, or a State Government.

Where the Central Government assign any case to the Serious Fraud Investigation Office for investigation under this Act, no other investigating agency of Central Government or any State Government shall proceed with investigation in such case. The Serious Fraud Investigation Office shall follow the manner and procedure as provided and submit its report to the Central Government. The Central Government may also direct to submit an interim report.

(3) Investigation into the affairs of a company in other cases as provided under Section 213*: The Tribunal may order investigation into affairs of the company, on an application received by specified number of members and supported by such evidence; or on an application made to it by any other person or otherwise, if it is satisfied that there are circumstances like, the business of the company is being conducted with intent to defraud its creditors, or that the company was formed for any fraudulent or unlawful purpose, or the members of the company have not been given all the information with respect to its affairs, etc. The investigation may be ordered, after giving a reasonable opportunity of being heard to the parties concerned.

It may be noted that if after investigation it is proved that—

- (i) the business of the company is being conducted with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose, or that the company was formed for any fraudulent or unlawful purpose; or
- (ii) any person concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct,

then, every officer of the company who is in default and the person or persons concerned in the formation of the company or the management of its affairs shall be punishable for fraud.

***NOTE:** Students may note that Section 213 of the Companies Act, 2013 is not enforced yet. Hence, the provisions of this section is not discussed in detail for the time being.

Who can be appointed as an Inspector - A firm, body corporate or other association cannot be appointed as an inspector. Thus, a firm of professional accountant cannot be appointed as inspector but an individual accountant can be so appointed.

Power of Inspector to conduct investigation into the affairs of related companies etc.- Section 219 of the Companies Act, 2013 provides that an inspector appointed under section 210 or section 212 or section 213 to investigate into the affairs of a company may also investigate, subject to approval of the Central Government, into the affairs of—

- (a) any other body corporate which is, or has at any relevant time been the company's subsidiary company or holding company, or a subsidiary company of its holding company;

(b) any other body corporate which is, or has at any relevant time been managed by any person as managing director or as manager, who is, or was, at the relevant time, the managing director or the manager of the company;

(c) any other body corporate whose Board of Directors comprises nominees of the company or is accustomed to act in accordance with the directions or instructions of the company or any of its directors; or

(d) any person who is or has at any relevant time been the company's managing director or manager or employee.

It may be noted that he shall, subject to the prior approval of the Central Government, investigate into and report on the affairs of the other body corporate or of the managing director or manager, in so far as he considers that the results of his investigation are relevant to the investigation of the affairs of the company for which he is appointed.

The objective of these investigations, fundamentally, is to determine whether any provision of the Act has been violated or there has been a breach of duty on the part of a director or an officer of the company resulting in a loss to shareholders or a class of them. It has been held in the case *Narayanlal Bansilal v. Maneck Phiroze Mistry and another (1960 comp. Cases, p. 62)* that an investigation into the affairs of a company under the Companies Act was not a criminal proceeding. It was also held that the report of the inspector is just an expression of his opinion in the manner in which affairs of the company was conducted.

The term "affairs of a company" was considered in *R.V. Board of Trade Ex. parte St. Martin Preserving Company Ltd. (1964 E.R. 561)*. It was held that it can cover investigations into all aspects of its business; its assets including goodwill, profits and losses, contracts and transactions, investments and rather property interests and control of subsidiary companies and transactions of a receiver and manager of a company.

PROCEDURE, POWERS ETC. OF INSPECTORS – Section 217 of the Companies Act, 2013 states the procedures, powers of the Inspectors as follows:

(1) **Duty of officers and employees of the company towards inspector:** It shall be the duty of all officers and other employees and agents including the former officers, employees and agents of a company which is under investigation to preserve and to produce to an inspector or any person authorised by him, all books and papers relating to the company or the person; and to provide assistance in connection with the investigation which they are reasonably able to give.

(2) **Inspector may ask information from any body corporate:** The inspector may require any body corporate, other than a body corporate referred to in point(1), to furnish such information to, or produce such books and papers before him as he may consider necessary.

(3) **Not to keep Books and Papers in custody for more than 180 days:** The inspector shall not keep in his custody any books and papers produced for more than 180 days and return the same to those by whom the books and papers were produced.

The inspector may call the books and papers again, if needed, for a further period of 180 days by an order in writing.

20.21 Advanced Auditing and Professional Ethics

(4) **Examine on oath:** The inspector may examine on oath any of the persons referred above; and with the prior approval of the Central Government, any other person in relation to the affairs of the company, or other body corporate or person, as the case may be.

(5) **Inspector to possess all the Powers of Civil Court:** The inspector, being an officer of the Central Government, making an investigation shall have all the powers as are vested in a civil court under the Code of Civil Procedure, while trying a suit in respect of specified matters.

(6) **Assistance of Officers of Government to Inspector:** The officers of the Central Government, State Government, police or statutory authority shall provide necessary assistance to the inspector for the purpose of inspection, investigation etc.

(7) **Evidence from place outside India:** If in the course of an investigation into the affairs of the company, an application is made to the competent court in India by the inspector stating that evidence may be available in a country or place outside India, such court may issue a letter of request to a court or an authority in such country or place for seeking such evidence.

It may be noted that the letter of request shall be transmitted in such manner as the Central Government may specify in this behalf.

INSPECTOR'S REPORT - Under Section 223 of the Companies Act, 2013, an inspector shall, if so directed by the Central Government, submit interim reports to that Government, and on the conclusion of the investigation, shall submit a final report to the Central Government. Every report made shall be in writing or printed as directed by the Central Government. A copy of the report may be obtained by making an application to the Central Government.

Section 224 of the Companies Act, 2013, deal with follow-up of the inspector's report and gives power to the central government to launch prosecution; apply for winding up of the company etc.

GENERAL APPROACH FOR INVESTIGATION - The general approach for investigation under Sections 210, 212 and 213 of the Companies Act, 2013 is conditioned by the legal requirements in these regards. From the foregoing requirements of law, it is apparent that investigations under these requirements may encompass a wide field. The affairs of the company may include everything such as goodwill, profit and loss, contracts, investments, assets, shareholding in subsidiaries, decision making, etc. Also the specific circumstances mentioned in these sections like fraud, mismanagement, oppression of any shareholder etc. come within the term "affairs of the company."

Investigation under Sections 210, 212 and 213 do not call for any special approach. The approach to any investigation is determined on a consideration of the nature of the investigation and the terms of reference. However, the inspector should ensure that the terms of reference are clear, unambiguous and in writing. If he has any doubt about any item in the terms, he should obtain clarification in writing. It should also be seen that the terms of reference are not too general, because that may frustrate the whole objective of the investigation; the scope of the investigation will become unwieldy and ill defined. An investigation order to investigate into the affairs of the company would be an instance at point. Affairs would mean anything and everything that the company is involved in. The thrust and sharpness of the investigation would get diffused and blunted and important distortions in the

company may be overlooked in the generalities of the scope. Therefore the inspector should ask for reframing of the order specifying the exact matters to be investigated. He should also take into consideration the possible effect of limitations, if any, put in the terms of reference and should keep the Central Government informed in writing about their effect on the investigation.

The next point for consideration of the inspector would be the determination of the scope of the investigation on the basis of the terms of reference. At this stage, it may be useful for the inspector to go into the history of the company and its affiliates or associates. He should evaluate the terms of reference in sketching the scope of investigation; this will enable him to locate the limitation, if any, in the terms of reference, not clearly mentioned. For a purposeful investigation, he may need to stretch his inquiry into the books and records of allied and associated persons and concerns and may require to arm himself with the powers given under Section 217 of the Companies Act. He should also have regard to the period over which the investigation should stretch. The evaluation of terms of reference and the consequential determination of the scope of investigation are the twin props on which the entire investigation would rest and, therefore, the inspector appointed should devote careful attention to these. Thereafter, he should frame his programme for investigation in a systematic manner. He should keep adequate working notes and papers with references and cross references in a proper and methodical way to aid him in the preparation of the report. The actual process of investigation would be essentially an evidence gathering procedure and, at every step, he should have regard to the procedures laid down in these sections regarding production of documents and evidence, examination on oath and seizure of documents. He should also keep his mind open to the revelations he comes across in the process of evidence collection and should assess whether the programme of investigation needs amendment or modification. He should also consider whether assistance of other experts like engineers, lawyers, etc., is necessary in the interest of a comprehensive and fool proof examination of the documents and information.

Only after he has completed the steps in the investigation programme and has marshaled all the information that he needed should he prepare his report. He, however, can make interim report also as provided under Section 223 of the Companies Act. The findings should be completed and exhaustive. Before he makes his final report he should obtain and keep on record the evidences relied upon by him. By the nature of things, such evidence should be as conclusive as possible depending on circumstances of the case. He should make his report in accordance with the provisions of 223 of the Companies Act. However, the overriding consideration that he should at every stage of investigation and especially in the report framing stage bear is to remain fair and thoroughly unbiased.

The general approach for investigations under Sections 210, 212 and 213 should, therefore, be formulated having regard to the terms of reference, scope, the period, the programme and procedure of the investigation and the attending legal requirements specified above.

(B) INVESTIGATION OF OWNERSHIP OF A COMPANY: According to Section 216 of the Companies Act, 2013, where it appears to the Central Government that there is a reason so to do, it may appoint one or more inspectors to investigate and report on matters relating to the

20.23 Advanced Auditing and Professional Ethics

company, and its membership for the purpose of determining the true persons, who are or have been financially interested in the success or failure, whether real or apparent, of the company; or who are or have been able to control or to materially influence the policy of the company.

While appointing an inspector, the Central Government may define the scope of the investigation as respects the matters or the period to which it is to extend. It may limit the investigation to matters connected with particular shares or debentures. Powers of inspectors shall extend to the investigation of any circumstances suggesting the existence of any arrangement or understanding.

Scope and extent of investigation - When a chartered accountant is appointed to carry out an investigation under any of the aforementioned provisions, the extent of enquiry, the objective of the investigation and the various matters referred to for investigation are specified in the order of investigation issued by the appointing authority. On a consideration thereof, the investigating accountant should determine the areas of accounts which require investigation and the extent to which the enquiry is to be made as well as his general approach to the enquiry. For example, if the allegation is that certain transactions have been entered into in contravention of the provisions of the Companies Act, the nature of transactions, the persons who were parties thereto, the amount or amounts involved and the circumstances under which these were entered into must be examined. If the contravention was deliberate and willful and was made with some ulterior motive, it would attract greater penalty as compared to the one which was inadvertent. The enquiry therefore should show the motive, if any, of the contravention. If the loss suffered by the company has given rise to a gain by a director and other managerial personnel or its associates, the manner in which the benefit has accrued and the amount thereof shall have to be investigated.

In case of a company having subsidiaries or where one or more directors are interested in one or more concerns, all the dealings with these concerns should be examined for these may have been entered into with the intention of transferring profit. Generally, all sales and purchases of goods and assets from directors and their associated concerns should be scrutinized since these also can be a vehicle of illicit transferring of profits.

Any breach of duty or abdication of responsibility for purposes of investigation would be material only if it has resulted in a loss to the company. In such a case, the factors responsible for the loss or losses, besides the amount thereof, shall have to be investigated. Negligence would be culpable only if it was in relation to a duty cast by the Act, Articles of Association or by a resolution of the shareholders or that of the Board of Directors.

Any negligence in the discharge of duty of a director or any other managerial personnel must be construed very broadly, for apart from being the agents of the company, they are trustees of its property. As such, it is their duty to safeguard the property of the company and protect the interest of the shareholders. It must be remembered, however, that it is not the duty of a director to attend to the business of a company continuously and, therefore, so long as the decisions of the Board at which the director was present were taken on a proper consideration of the evidence available and in the best interest of the company, he would not be responsible for any losses suffered by the company.

It may be necessary for an investigator to interrogate directors, officers, agents, and others concerned with matters under his enquiry. Before drawing up his brief in this regard as well as for framing his conclusions, he should, if necessary, take legal assistance. If the Investigating accountant is required to report on the efficiency of the management, he should be discreet in expressing his opinion. Usually, it is sufficient if he merely indicates the general limitations of the management. The inspector must ensure that the persons who figure in the investigation get the fullest opportunity to explain their action and conduct. However, the inspector cannot hold out any assurance to anybody except the assurance of fairness implicit in the job.

20.6.2 Investigation on behalf of an incoming partner

The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm—manufacturing, trading or rendering a service.

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit in the shape of return on capital to be contributed and remuneration for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully.

Broadly, the steps involved are the following:

- (a) Ascertainment of the history of the inception and growth of the firm.
- (b) Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.
- (c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.
- (d) Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those for pending tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.
- (e) Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.

20.25 Advanced Auditing and Professional Ethics

- (f) Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence should be studied.
- (g) It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.
- (h) Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.
- (i) Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.
- (j) Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.
- (k) It would be useful to have a firsthand knowledge about the specialisation, if any, attained by the firm in any of its activities.
- (l) Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.
- (m) Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms.
- (n) Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

It would always be worthwhile to remember that, in a partnership, personal considerations count predominantly over other considerations and assessment of standing of the firm, standing and reliability of other partners, their personal reputation and the goodwill enjoyed by the products/services are important.

On the basis of the broad frame of considerations as given above, the investigating accountant should devise his own considerations in each case which may be quite diverse. Additional considerations may come up in the case of service-rendering firms where profit and business record, goodwill of the firm and of individual partners would assume greater significance.

Again, in the case of industrial firms, the network of customers, their scatter, size, etc., would be relevant for consideration.

20.6.3 Investigation for valuation of shares in private companies

The importance should be given on various purposes for which such a valuation is necessary, the different bases on which valuation is possible and the variety of economic factors, on a

consideration whereof the price so determined needs to be adjusted.

The necessity for valuation of shares of a private company arises, for under the Companies Act, a private company must restrict the transfer of its shares. In consequence, the shares of a private company do not have a free market in which their prices could be determined by interaction of the forces of supply and demand.

In respect of equity shares, there are two main methods of valuation. According to the *first* method, value is determined on the basis of net worth of the company. The amount of net worth is divided by the number of shares comprising the equity capital to arrive at the value for one share. When this method is followed, goodwill of the business, based on the estimated future maintainable profit, is included among the assets to arrive at the amount of net worth. According to the *second* method, the average profit earned by the business during the preceding 5 to 7 years is computed. Afterwards, on the assumption that the same would continue to be earned in the future, the value of business is calculated by capitalising it at a reasonable rate of interest. If the rate assumed is high, the value of the business would be smaller. Correspondingly, it would be high if the rate of interest applied is low. A provision of the risk factor and restriction on transfers in the value of shares is made by varying the rate of interest applied. The rate of return that an investor expects to earn in a business of the type in which the company is engaged, is ascertained from the prices of the shares of companies engaged in a similar business quoted on the stock exchange.

The value of preference shares is estimated on the basis of the yield on preference shares of companies engaged in a similar trade or industry after making allowance for factors like restriction on transferability, average rate of earnings as compared to the rate of dividend, etc.

Special features -

Net worth basis

- (a) Each asset should be revalued on taking into account its utility to the business as a going concern. The value of different assets, on a revaluation, may be either more or less in comparison to their book values. For example, the book value of safes and furniture in the case of a bank is usually much less as compared to their utility. On the other hand, the book value of intangible assets, e.g., leasehold rights, patents, goodwill, etc., in case of an industrial concern may be higher in comparison with the advantage which accrues to it from these assets. In both the cases, the assets should be revalued at their replacement cost i.e., the cost of similar assets at the prevailing market price, reduced by the amount of depreciation which they would have suffered, if they were in use during the period that the corresponding assets have been in use. But the cost adopted, in cash, should be the cost of the assets as were originally purchased or that of their substitutes considered more suitable in the circumstances of the case.
- (b) The value of goodwill of a business is primarily dependent on its capacity to earn super-profit and the period over which these are expected to arise. The super profits that the business would earn in the future are estimated on the basis of profits earned in the past, after making an allowance therein for the continuation or otherwise of favourable factors, which in the past had enabled the business to earn super-profits. This is usually a difficult

20.27 Advanced Auditing and Professional Ethics

matter since, for the purpose, it is necessary to analyse the trend of economic, social and political forces which have an impact on the profitability of the business. For instance, the installed capacity must be viewed against future national requirements on taking into account the government's licensing policy. Again, government policies like controls over selling price or advantages of marketing through its own organisations will have to be considered since any change therein might seriously affect the profit structure. Therefore, to determine the impact of these factors, the accountant must have knowledge of the company's working and experience of the business in general.

Yield basis

- (a) The value of shares on yield basis is arrived at on the basis of present value of the right to receive dividends in the future. Since dividends can be paid only out of profits, in this case also, it is necessary to determine the amounts of profits which the company would be earning in future as well as the amounts thereof which would be distributed as dividend from year to year. In short, it is an exercise in projecting the trend to profits and predicting the policy that the company might follow in the matter of declaration of dividends.
- (b) The rate at which the amount of dividends should be capitalised is decided on taking into account the risk that shareholders are taking in the matter of declaration of dividends being continued in future, assessed in the background of past history of the company, the amount of reserves the company possesses, both secret and those disclosed in its books, future prospects of the line of manufacture or trade in which the company is engaged and the impact of various social and political factors that are likely to emerge on the company's profitability. Since the effect of these factors is reflected in the prices at which the shares of companies engaged in similar trades and businesses are quoted on the Stock Exchange, the investigating accountant should consider them. These would show to him the rate at which their dividends were being capitalised. He should adopt the average rate of return expected by investors in the shares of such companies but it should be applied only after making due allowance for the factors peculiar to the case, such as restrictions on transfer of shares, majority holding, etc. In any valuation of shares, with the transfer of shares control is also to pass, a separate value should be ascertained for the control and added to the value otherwise obtained either on net worth basis or yield basis.

20.6.4 Investigation on behalf of a bank proposing to advance loan to a company

A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under-mentioned points:

- (i) The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.
- (ii) The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and

the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for payment of loans on the reliability of annual profits and loss on the values of assets mortgaged to them.

- (iii) The financial standing and reputation for business integrity enjoyed by directors and officers of the company.
- (iv) Whether the company is authorised by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.
- (v) The history of growth and development of the company and its performance during the past 5 years.
- (vi) How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

- (a) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.
- (b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:
 - (i) Sales to Average Inventories held.
 - (ii) Sales to Fixed Assets.
 - (iii) Equity to Fixed Assets.
 - (iv) Current Assets to Current Liabilities.
 - (v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.
 - (vi) Equity to Long Term Loans.
 - (vii) Sales to Book Debts.
 - (viii) Return on Capital Employed.
- (c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating

20.29 Advanced Auditing and Professional Ethics

accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) **Fixed assets** - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) **Inventory** - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(c) **Trade Receivables, including bills receivable** - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

- (i) debts due in respect of which the period of credit has not expired;
- (ii) debts due within six months; and
- (iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(d) **Investments** - The schedule of investments should be prepared. It should disclose the - date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(e) **Secured Loans** - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures

have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

- (f) **Provision of Taxation** - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears to be inadequate, the fact should be stated along with the extent of the shortfall.
- (g) **Other Liabilities** - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.
- (h) **Insurance** - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.
- (i) **Contingent Liabilities** - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

20.6.5 Investigation of Frauds

In the Companies Act, 2013 meaning of fraud has been considered in two specific sections viz. Section 143(10), where the SAs specified by the ICAI are deemed to be the auditing standards for purposes of the Act, which, inter alia, define fraud, and in Section 447, where punishment for fraud has been prescribed.

Fraud has been defined in paragraph 11(a) of SA 240, "The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements" as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.'

In the context of stating the provisions for punishment for fraud, Section 447 of the Act has explained the term 'fraud' as "fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss."

20.31 Advanced Auditing and Professional Ethics

This Section further explains the terms 'wrongful gain' and 'wrongful loss' to mean the gain by unlawful means of property to which the person gaining is not legally entitled; and the loss by unlawful means of property to which the person losing is legally entitled, respectively.

Frauds may be classified as defalcations involving misappropriation, either of money or that of goods, and manipulation of accounts not involving a defalcation. The detections of manipulations of accounts being one of the objects of an audit, for the detection of frauds perpetrated for misappropriating either money or goods, knowledge of the various circumstances under which these may be committed and that of different forms they take is essential. On this account, a brief description thereof at different level is given below.

1. Fraud for Personal Gain

Bribery: Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver. These are also relatable to contract fraud or procurement fraud and are, generally, out of books transactions. The auditor normally conducts a propriety audit over the veracity of the transactions and review of any undue favours to vendors.

2. Corporate Frauds/ Irregularities

(i) **Advance Billing:** Advance billing is a situation where the company officials indulge in booking fictitious sales in anticipation of actual sales. This results in misrepresentation of revenue in the books thereby misleading financiers and stakeholders. When the management treats borrowings from money lenders as customer advances in the books against sale orders or for adjusting bills receivables, the fraudulent act gets unnoticed for an extended period. This situation results in a death knell for the corporation as the company is dragged into an irredeemable debt trap.

Use of Shell Company, false vendors, purchases of personal nature booked as official expenses enable falsification of accounts and diversion of funds for purposes other than an intended purpose. These could also be mechanism for employees or cartel of employees engaging in personal gain at the cost of the company. In the former incident this could be termed as management fraud.

(ii) **Shell/ Dummy Company Schemes:** Generally, represents a fictitious company or a 'paper company' to transfer profits or funds from the main company. This could also involve fictitious bills (mostly for services rendered or consultancy charges that cannot be corroborated) which are used in the name of dummy companies diverting the funds taken from banks and financial institutions.

The books could be falsified by wrong classification of expenses, inflating the expense claims, fictitious expenses or multiple reimbursements. A review of controls, normally, leads to the uncovering of expense booking that are prima facie not incurred.

(iii) **Money Laundering Activities:** As per the Prevention of Money Laundering Act, 2002 whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering."

The person indulging in money laundering looks for avenues with weak banking controls for converting illegal money into the banking system. Any excess credit in the bank accounts that does

not belong to the customer or is parked for a temporary period should raise suspicion of such activities. This person indulging in money laundering activity looks for avenues to enter into 'benami' (could be called 'proxy' name lending) transactions. Companies with extensive cash handling and inadequate identification process of source of money or about the remitter are susceptible to money laundering activities.

3. Fraud at Operational Level Employees

(i) Tampering of Cheques/Drafts/On-line payments/receipts: Tampering of cheques, payee name being altered, or preparation of cheques without issue of the cheques to payee, etc., are methods that may also lead to falsification of accounts.

On-line payments generally are considered a transparent mechanism to prevent the above frauds. The ATM is a popular technological advancement that has inherent control gaps. For example, credit cards once swiped the transaction is put through in the system without the need for a signature of the payer. Similarly, unauthorised credits in bank accounts through ATMs are an immense source of threat to recipients including bribery allegations, unless they lodge a complaint with the bankers or the regulatory authorities in a prompt manner of such unauthorised credits to their accounts/or company bank accounts.

Care should be taken that the name of the payee in the payment transactions in books and cheque issued therein for payment is not fabricated to wrongly codify and book against an improper account head.

(ii) Off Book Frauds: In off book frauds, the fraud perpetrator misappropriates the cash before these are recorded in the books or before the sale is recorded in the books. These frauds are difficult to unearth as the cash or collection is taken off before the accounting entries are made in the books. This situation arises especially in unorganized markets and in rural economies where banking habits are relatively under developed. These are difficult to establish due to absence of audit trails and are more prevalent in businesses that have extensive cash dealings. These are difficult to uncover as the means adopted could include printing of receipts/ bills outside the system.

The above fraudulent schemes can be established based on circumstantial evidence or validation through external sources such as, customer balance confirmations (where feasible) and customer copy of the receipts or other documents that are retained by them. These are also further supplemented by external evidence in the form of background checks and surveillance mechanism.

(iii) Cash Misappropriation: Cash is misappropriated after the accounting entries are already passed in the books. These are identified through surprise checks and through shortages in cash balances. These occur when there are delays in accounting of cash collections and there are no laid down cash flow controls. Unaccounted money in any form in an entity is a serious red flag in uncovering of irregularities. Improper daily fund monitoring mechanism is another factor that results in creating unauthorised float by employees in their personal account or in fictitious surrogate (proxy) entities by fraudsters.

(iv) Teeming and Lading: This is also achieved through cash deposits or cheques collected from customers being overlapped with the collections from subsequent customers and the amount

20.33 Advanced Auditing and Professional Ethics

collected is diverted to personal account. The ageing of receivables is not a constant, and, therefore, this makes the task of identifying the leakage of collections unless all the customer accounts are reconciled at a single point of time.

(v) Fraudulent Disbursements: Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills. The other method that is resorted to by the perpetrator of fraud is to inflate the refunds due to a customer and skim the excess refunds.

(vi) Expense Reimbursement Schemes: These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement. In some cases, employees may get reimbursed by third parties (such as distributors) as well as by claiming these expenses from the company. Multiple expense claims based on duplicate bills or photostat copies.

(vii) Payroll Fraud: The payroll fraud could include payment to non-existent employees or in a contractual arrangement inflating of the manpower resources than those actually deployed while billing the client. It may also include showing higher pay than actual disbursement to employees/workers, etc. The process would require a detailed review of statutory declarations/filings under various labour law statutes including disclosures in financial statements of retirement benefits such as P.F, Gratuity and Superannuation benefits from an evidence gathering perspective.

(viii) Commission Schemes: The salesman exaggerates the sales through fictitious billings to earn higher commission or alter the sales prices of the products sold from those stipulated by the company or share the sales volumes achieved with other employees to share higher commission. Commission schemes in mega deals backed by legal documents are often tools used to camouflage kickbacks. These are often difficult to uncover and would need to be supplemented by the monetary trails across entities and geographies.

Procedure for Investigation of Fraud: Before proceeding to investigate frauds of the type afore-mentioned, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation. At times, an accountant is called upon to investigate a suspected fraud, the details or the nature whereof is not known. In such a case, for localising the source of the fraud, the investigating accountant will have to study the financial and accounting structure of the organisation. As a first step, he should examine the line of responsibility between the various members of the staff. He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons, without any supervision by any other person or any other inherent weakness that may be in existence in the system.

Some of the situations in which money may be embezzled and the various forms that such frauds usually take place alongwith their investigation procedure include the following:

- (a) **Cash receipts** - In cases like holding back cash sales, collections by travelling salesmen, V.P.P receipts, or casual receipts, e.g., sales of scrap, recoveries out of debts written off earlier, etc., the amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under-mentioned devices:
- (i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.
 - (ii) Showing a larger cash discount than actually allowed.
 - (iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.
 - (iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.
 - (v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.
 - (vi) Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.
 - (vii) Under-casting the receipts side of the Cash Book or over-casting the payment side; carrying over a shorter total of the receipts from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the next with a view to covering up misappropriation; either short banking of cash collection or apart of the amount withdrawal from the bank.

Verification of Cash Receipts: On the assumption that some of these may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts. Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier. In addition, by recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book. The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated. Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed. All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

20.35 Advanced Auditing and Professional Ethics

(b) Inflating cash payment -

- (i) Making double payment of an invoice or paying a false invoice.
- (ii) Paying personal expenses out of the business by falsifying details. e.g., showing betting losses as advertisement charges.
- (iii) Withdrawing unclaimed credit balances of customers or amounts falsely credited in the accounts of parties.
- (iv) Falsely adjusting a refund in the account of a customer and withdrawing the credit balance.
- (v) Wrong totalling of the wage sheets and misappropriating the excess amount withdrawn from the bank for payment of wages.

Verification of Cash Payments: All the evidence as regards cash payments made, including acknowledgement by parties for payments shown to have been made to them, should be carefully scrutinised. In the case where a figure appears to have been erased or altered on the receipts issued by the party, on reference to the party concerned, the actual amount paid to him should be confirmed. The same procedure should be adopted in respect of amounts acknowledged on blank papers. All payments by bearer cheques should be examined. The system of recording of wages should be reviewed, specially as regards possible over-totalling of wage sheets, and entries in them of dummy workmen. The system of ordering and receiving goods should be reviewed so as to confirm that no payment has been made in respect of supplies which have not been received. Confirmations should be obtained from partners or Directors in respect of amounts shown to have been paid to them.

The Petty Cash Book should be vouched and totaled. Special attention should be paid to payments made on account of salaries and wages; confirmation should be obtained from the management that all payments of such salaries and wages were made to persons who were actually in the service of the company. All the withdrawals from the bank should be checked by reference to entries in the bank's pass book. All the bills receivable or payable should be checked by reference to the Bills Books.

(c) Frauds through suppliers' ledger -

- (i) Adjusting fictitious or duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.
- (ii) Suppressing the Credit Notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.
- (iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.
- (iv) Accepting purchase invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers.

Verification of balances in suppliers' ledger - The Bought Journal should be vouched by reference to entries in the Goods Inward Book and the suppliers' invoices to confirm that amounts credited to the accounts of suppliers were in respect of goods, which were duly received and the suppliers' accounts had been credited correctly. All the suppliers should be requested to furnish statements of their accounts to see whether or not any balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted.

(d) Customers' ledger -

- (i) By the 'teeming and lading' method, i.e., misappropriating the amount collected from a customer and crediting his account by the amount paid by him only when an amount is subsequently collected from another customer; repeating this practice with several items collected and depositing back the amount or amounts so misappropriated before the close of the year.
- (ii) Misappropriating the amount collected from a customer and subsequently adjusting his account by crediting the amount on account of allowance or a rebate for excess price charged.
- (iii) Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.

Verification of balances in customers' ledger: Special attention should be paid to allowances adjusted on account of goods returned or difference in price or on any other account as well as to amounts written off as bad debts. To confirm that the accounts of customers have been debited in respect of goods supplied to them, entries in the Order Book should be tested with those in the Sales Day Book where one is kept. The investigating accountant should obtain confirmation of customers in respect of the amounts standing in their accounts. Those of them who have no balance in their accounts should be requested to confirm the statement of their account (which should be sent to them) for ascertaining that the entries shown therein were genuine.

(e) Inventory frauds-Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

- (i) Employees may simply remove goods from the premises.
- (ii) Theft of goods may be concealed by writing them off as damaged goods, etc.
- (iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and despatch of all goods, etc. should be reviewed to localise the weakness in the system.

20.37 Advanced Auditing and Professional Ethics

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of: (a) a system of inventory control, and existence of detailed record of the movement of inventory, or (b) availability of sufficient data from which such a record can be constructed. The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent. The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

20.6.6 Investigation on behalf of an individual or firm proposing to buy a business

Scope of investigation - The objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worthwhile to buy the business and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given.

(A) In case of proprietary concerns or partnerships -

- (i) Reasons for the sale of the business and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).
- (ii) The length of lease under which the premises are held; the prospects of its renewal or extension.

- (iii) The unexpired period of any patents owned by the vendors.
 - (iv) The age of the present managerial staff and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees and those retrenched.
 - (v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.
 - (vi) The valuation that could be placed on goodwill to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.
- (B) If the business belongs to a limited company** -The vendors' interest in this case will be purchased by the acquisition of shares. On that account, the following additional matters would also require consideration:
- (i) The authorised and issued capital of the company.
 - (ii) Whether there is any uncalled liability on the shares.
 - (iii) If the capital is divided into different classes of shares - the rights that are attached to each class.
 - (iv) Particulars of dividends paid in the past and the amounts thereof which are in arrear (on cumulative preference shares).
 - (v) If there are any mortgages created on the assets appearing in the company's books, a search should be made in the Register of Charges in the office of the Registrar of Companies.
 - (vi) The price at which the shares are being offered. If the company is a public company, the price will usually be in excess of market price quoted on the Stock Exchange, but in the case of unquoted shares particularly where the company whose shares are being acquired is a private company, a valuation will have to be placed on the shares for the purpose of purchase.

20.6.7 Investigation in connection with review of profit/financial forecasts

There are many investigations which involve an examination of future profits. Profit reports can be required as part of a general investigation into the purchase of a business or by banks and financial institutions with regard to project cash flow and profitability statements for appraisal of loan applications submitted by the intending borrowers. All forecasts depend, to a large extent, on the nature of the business with its numerous and substantial uncertainties. Therefore, such forecasts are not capable of verification by the reporting accountants in the same way as financial statements which present the results of a completed accounting period. Normally, such situations involve special review as these depart from the auditor's traditional role of expressing an opinion in relation to past events.

20.39 Advanced Auditing and Professional Ethics

For quite a long time, professional accountants have been involved in the preparation or review of profit forecasts to be submitted by intending borrowers to banks and financial institutions. These institutions place a greater reliance on such statements if they are prepared or reviewed by chartered accountants. As a large number of chartered accountants are undertaking the preparation and review of profit and financial forecasts for submission to banks and financial institutions, the ICAI had issued a guidance note on this subject. The guidance note discussed various considerations and important matters to which the accountants should direct their attention in reviewing the forecasts. It also contained guidelines for preparation of the report. Pursuant to the growing implications in this arena, ICAI issued SAE 3400 on “Examination of Prospective Financial Information” to deal with the subject matter. Consequent upon to the issue of this Standard, the erstwhile Guidance Note stands withdrawn.

20.7 Due Diligence

Due Diligence refers to a comprehensive appraisal of a business undertaken by a prospective buyer/investor, specifically to establish its assets and liabilities and ascertain its commercial potentiality. It is a term that is often heard in the corporate world these days in relation to corporate restructuring. The term '*corporate restructuring*' normally includes internal reconstruction, amalgamations, spin-offs, divestiture, mergers, joint ventures, split-off, etc. Certain corporate restructuring exercises are not within the group (also known as external corporate restructuring exercises), for example, a joint venture between two parties where one party hives off an existing unit or division into another company into which the joint venture partner then acquires an interest or has acquired an interest. These are all corporate restructuring exercises that involve more than one party. For such a corporate restructuring exercise to succeed, it must be planned properly. A key element in such an exercise, where it involves the acquisition of another entity, unit or assets of an entity, is the performance of a “due diligence” review.



FIG. 1: Image showing due diligence file*

Due Diligence may also required to be performed in cases of venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc. Sometimes, in a restructuring exercise, while the unit may remain within a group, it may pass from under the charge of one management team to that of another team. This situation also gives rise to the need for a due diligence review.

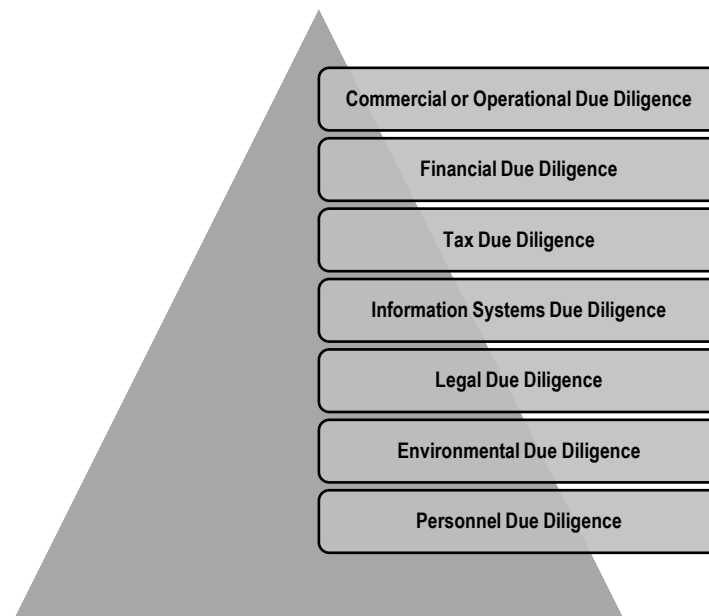
Purpose of Due-Diligence - The purpose of due diligence is to assist the purchaser or the investor in finding out all the reasonably can about the business he is acquiring or investing in

* Source: www.lyagency.co.ke

prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

In addition, it may expose problems or potential problems that can be addressed in the price negotiations or by dealing suitable clauses in the contractual documentation, in particular, warranty and or indemnity provisions.

Due Diligence can be sub-classified into discipline-wise exercises in following diagram:



20.7.1 Commercial or operational Due Diligence

Operational due diligence is generally performed by the concerned acquirer enterprise (due diligence may also be commissioned by the enterprise for the sale of its business or part of a business), and involves an evaluation from a commercial, strategic or operational perspective. For example, whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may, in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate.

20.7.2 Financial Due Diligence

At times, the financial due diligence review is interpreted as complete due diligence review since it is supposed to ascertain the financial implications of all the other due diligence reviews. This is, however, not appropriate. The term 'financial due diligence' should be used with caution. Unless the scope of financial due diligence to be performed is wide enough to cover all the aspects, it should not be confused with overall due diligence review.

It can be understood from the foregoing that the role of financial due diligence commences after a price has been agreed for the business. The initial price and other decisions are taken on the basis of net worth as well as trend of profitability of the target company, with an assumption that all contingent liabilities that may impact the future of the business have been recorded. The principal objective of financial due diligence, therefore, is usually to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired/merged with.

In order to achieve its objective, the due diligence process can include any or all of the following objectives for individual areas of the verification:

- ◆ Brief description of the history of business
- ◆ The background of promoters
- ◆ Accounting policies and practices
- ◆ Management information systems
- ◆ Details of management structure
- ◆ Trading results both past and the recent past
- ◆ Assets and liabilities as per latest balance sheet
- ◆ Current status of Income tax assessments including appeals pending against tax liabilities assessed by tax authority.
- ◆ Cash flow patterns
- ◆ The projection of future profitability

If a full fledged financial due diligence is conducted, it would include the following matters, *inter alia*, in its scope:

- (a) Brief history of the target and background of its promoter
- (b) Accounting policies
- (c) Review of financial statements
- (d) Taxation
- (e) Cash flow
- (f) Financial Projection
- (g) Management and employees

(h) Statutory Compliance.

(a) Brief history of the target and background of its promoters - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations. This could, inter alia, include the following:

- ◆ Nature of business(es) (for example, manufacturer, wholesaler, financial services, import/export).
- ◆ Location of production facilities, warehouses, offices.
- ◆ Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation).
- ◆ Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes).
- ◆ History of the business with important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time").
- ◆ Inventories (for example, locations, quantities).
- ◆ Franchises, licenses, patents.
- ◆ Important expense categories.
- ◆ Research and development.
- ◆ Foreign currency assets, liabilities and transactions.
- ◆ Legislation and regulation that significantly affect the entity.
- ◆ Information systems.

(b) Accounting policies - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale. The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the

20.43 Advanced Auditing and Professional Ethics

accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

(c) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being that the price of the target would be largely based upon its operating results. The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. This comparison could lead the accountant to the reasons behind the variations. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. In the case of many enterprises, the valuation is mainly based on the value of net assets only. For valuation of immovable properties and plant, if required, the assistance of expert valuers could also be taken. The exercise to evaluate the balance sheet of the target company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities. The accountant should pay particular attention to the valuation of intangible assets. The objective of the Due Diligence exercise will be to look specifically for any hidden liabilities or over-valued assets.

Examples of Hidden Liabilities are:

- ◆ The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- ◆ The company may have given "Letters of Comfort" to banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.

- ◆ The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- ◆ Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- ◆ Tax liabilities under direct and indirect taxes.
- ◆ Long pending sales tax assessments.
- ◆ Pending final assessments of customs duty where provisional assessment only has been completed.
- ◆ Agreement to buy back shares sold at a stated price.
- ◆ Future lease liabilities.
- ◆ Environmental problems/claims/third party claims.
- ◆ Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- ◆ Huge labour claims under negotiation when the labour wage agreement has already expired.

Examples of Over Valued Assets could be:

- ◆ Uncollected/uncollectable receivables.
- ◆ Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- ◆ Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- ◆ Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- ◆ Litigated assets and property.
- ◆ Investments carried at cost though realizable value is much lower.
- ◆ Investments carrying a very low rate of income / return.
- ◆ Infructuous project expenditure/deferred revenue expenditure etc.
- ◆ Group Company balances under reconciliation etc.
- ◆ Intangibles of no value.

(d) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. The accountant has to also look at the tax effects of the merger or acquisition.

(e) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important

20.45 Advanced Auditing and Professional Ethics

to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check if a) Is the company able to honour its commitments to its trade payables, to the banks, to government and other stakeholders b) How well is the company able to turn its trade receivables and inventories c) How well does it deploy its funds d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(f) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the target to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that the accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that an assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

(g) Management and Employees - In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I.), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary. The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(h) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those

laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

20.7.3 Contents of a Due Diligence Report

The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

Example of Headings of a Due Diligence Report

- ◆ Executive Summary
- ◆ Introduction
- ◆ Background of Target
- ◆ Objective of due diligence
- ◆ Terms of reference and scope of verification
- ◆ Brief history of the company
- ◆ Share holding pattern
- ◆ Observations on the review
- ◆ Assessment of management structure
- ◆ Assessment of financial liabilities
- ◆ Assessment of valuation of assets
- ◆ Comments on properties, terms of leases, lien and encumbrances.
- ◆ Assessment of operating results
- ◆ Assessment of taxation and statutory liabilities
- ◆ Assessment of possible liabilities on account of litigation and legal proceedings against the company
- ◆ Assessment of net worth
- ◆ Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account
- ◆ SWOT ANALYSIS
- ◆ Comments on future projections
- ◆ Status of charges, liens, mortgages, assets and properties of the company
- ◆ Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities
- ◆ Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition

CASE STUDIES

I. Excess Claim for Loss of Stocks

This is a case study of an investigation in respect of a major insurance claim where an investigator was appointed by surveyors for evaluation of stocks.

Introduction

An investigator (for that matter even an auditor, whether statutory, Internal, or Concurrent) has to be attentive to deficiencies or weaknesses in internal controls. Such deficiencies or weaknesses expose the client to possibilities of errors and frauds. The significant difference between the two is that errors are a result of either inefficiency or oversight, while frauds are the result of shrewd planning by the fraudster. Further, errors can be more easily located since they would have been inadvertently committed without any intention of concealment, while camouflaging of frauds would be deliberate and intelligent. Therefore, the investigator (or auditor) has to modify his approach in circumstances where fraud is suspected.

It is always advisable for an investigator (or auditor) to review all his findings objectively towards the completion of the assignment, just before finalizing his report. This would enable him to have an overview of all his observations. He must ask himself "Do all the facts and pieces of evidence fit in logically? Is there any indication of mismatching of facts? Do the data tie up with the current, circumstances? Is there any unusual or strange pattern?" A study of the findings is likely to give him a wealth of information. This exercise may reveal latent errors or frauds.

The following case study explains how an investigator was able to detect a major insurance fraud.

Facts of the case

ABC was a partnership firm trading in television sets. It stocked several models of television sets of various companies. The stocks were kept at a warehouse. After an outbreak of fire in the warehouse, ABC lodged a claim with the insurance company. The claim was for ₹ 200 lacs for about 1550 television sets. Stock records which were maintained at the warehouse included the following:

1. Goods Inward Notes
2. Delivery Challans
3. No Charge Invoices for free replacements
4. Stock Ledger (ledger page for each model of television)

A parallel stock, ledger was maintained at the office also.

The insurance company sent an investigator to assess the claim of ABC. Since the warehouse was completely reduced to cinders, the only quantitative record available was the stock ledger at the office. The investigator went about his task meticulously. First he gathered all the routine information — list of books of account, purchase and sales procedures, levels of authorities in force, and list of suppliers and customers. He also documented, in brief, the nature of the business and the background of the owners. Since his focus was on the insurance claim. He concentrated his efforts on the examination of stock ledger, purchases and sales.

Investigator's approach and plan

The investigator conducted the investigation with two broad objectives in mind:

- (a) To assess the correctness of the quantities of the stock-on-hand as on the date of fire.
- (b) To satisfy himself that the valuation was fair and reasonable.

As regards (a), he adopted the following procedure:

- (i) He traced the opening balances from the last audited physical verification statement.
- (ii) He checked the castings of the stock ledger for all the quantities received and sold.
- (iii) He traced quantities of goods received from the Purchase Register and suppliers' challans (since GRNs were lost).
- (iv) He traced quantities of goods sold from the sale register.
- (v) He traced the free replacements from the Claims Register and obtained confirmations in writing from the partners that barring those shown in the register, there were no other free replacements.
- (vi) He listed damaged or defective stock on the basis of the Claims Register.
- (vii) He traced quantities of returns from both credit notes and debit notes into the stock register.
- (viii) He could not get any feedback from the storekeeper since the latter had been hospitalised after the fire and had subsequently gone back to his village.

As regards the findings, he had nothing unusual to report. Everything seemed to be correct. All the checks detailed above did not reveal any discrepancy.

As regards (b), the procedure was fairly simple since it was only a trading firm. The firm had adopted the FIFO basis of valuation and, therefore, the cost of stock was derived from the latest purchase bill. The insurance company was satisfied with this because, as per the policy, it had to reimburse the claimant at the 'replacement value'.

The investigator then decided to examine all the facts collectively before finalising his report.

Results and findings

Though he did not have any specific query, the following observations were unusual:

- ◆ The past audited physical verification statement as well as the earlier balance sheets of the firm disclosed stocks which were less than 50 % of the stocks value as on the date of the fire.
- ◆ Faxed orders-on-hand as on the date of fire did not even add up to 15 % of the stocks claimed to have been lost.
- ◆ Some of the purchases during the last few days before the fire were made without any advance being paid. In the past, by and large, purchases were made with 50% advance to suppliers. The payments were made after the date of fire.
- ◆ Suppliers' challans for the purchases stated above did not bear the usual godown keepers' signature.

20.49 Advanced Auditing and Professional Ethics

All these facts led the investigator to believe that the stocks had been overstated in the claim. However, none of these observations were really sufficient for him to conclusively prove that stocks were overstated. He asked the firm for explanations which were given in respect of each of the above observations as follows:

- (a) The increase in the quantum of stocks was due to major sales drive which the firm was proposing to launch shortly. They had been negotiating a major order with a new client, which was in the process of finalisation.
- (b) A lot of verbal and telephonic orders were received as on the date of fire.
- (c) Due to growing competition, some of the suppliers were willing to favour the Firm by not insisting advance payments.
- (d) Due to heavy traffic, a large consignment of stocks came late at night when the usual warehouse keeper was not there and one of the partners had himself come and accepted the stocks.

Obviously, some concrete evidence was required to disprove the claim. The investigator decided to visit the warehouse to see if any more evidence was available. It was at the warehouse that he hit upon the solution to the problem of proving the absurdity of the claim. The dimensions of the warehouse apparently did not seem to practically permit more than 1000 television sets to fit in. He called for the layout of the warehouse and took the actual measurements of the smallest television set stocked by the firm. Even if these had been the only sets stocked by the firm, not more than 1200 sets could be fitted in the godown without even providing for space for human movement. Also, stacking norms permitted only 3 television boxes in a column, further restricting the number of sets, which could be stored. When these queries were raised, the firm accepted that there seemed to be an 'error' and reduced the claim unconditionally.

Lessons to be learnt

Dimensional limits of storage of assets can be the most important consideration in determination of an asset quantification. It is logical to presume that the inventory cannot be more than:

- (a) The physical limits of space available.
- (b) The permissible storage facility. The storage facility limits may not merely be on account of dimensions. For instance, stocks may be governed by stocking norms for safety or prevention of damage. To illustrate a godown having stacks of pressure cookers may have a height to accommodate 15 pressure cookers, but storage may not be permitted over 10 cookers cartons vertically since the cookers may not be able to withstand the weight of more than 9 cartons on top.
- (c) Legal constraints.
- (d) Certain items of plant and machinery may technically require certain open space or clear area surrounding it or on top thereby restricting the number of such assets in a given area.

Wherever the investigator (auditor) deems fit, he should obtain technical guidance on the storage and custody of the assets as per the plan and layout furnished by the client. This would give the investigator (auditor) the upper limit of the asset quantification with suitable.

Modifications and adjustments for stocks lying with third parties and third party stocks lying with the client.

The point that this case study highlights is that an effective investigation warrants all the examination and review procedures are adopted in harmony and objectively. The findings have to be viewed both individually and collectively and the results must ring true. Illogical trends, patterns or mismatches of facts are the significant pointers to the investigator or auditor, as the case may be. It is up to him to examine them and draw his conclusions appropriately.

II. Embezzlement of Cash

This is a case study where an investigator was appointed by an insurance company to assist the surveyors in investigating into a major insurance claim involving embezzlement of cash.

Introduction

Man has been known to exploit situations of crisis and disaster, because human, nature is frail and easily susceptible to temptation. Accordingly, an investigator needs to be alert to the increased probability of fraud in circumstances of disaster and crisis. The following is a case, which amply illustrates this point.

Facts of the case

A supermarket, having a very large turnover in cash sales of all kinds of items such as groceries, foodstuffs, sweets, chocolates, meat, and other related items, was severely looted during an outbreak of riots and was literally reduced to shambles. Foodstuffs, sweets, and other traded items were looted or strewn all over. The supermarket remained shut for a few days after the riots since the stocks and scraps could not be disposed of until permitted by the Police and the insurance company. A police complaint was filed but the stolen goods and cash could not be recovered. The insurance company started making preparations for assessment of the claim. As per the standard approved procedure, insurance surveyors were appointed to assess the claim for:

Loss of stocks: ₹ 1.25 crores.

Loss of cash : ₹ 1.5 lacs. An amount of ₹ 8 lacs was left back in the cash box which had been forcibly broken open.

Investigator's approach and plan

The surveyors appointed a chartered accountant as an investigator to help them in evaluating the claim. The following procedures were performed by him:

- (a) Photographs and a video film of the site evidencing the actual damage were examined.
- (b) Copy of the police complaint was obtained and kept on record.
- (c) Books of account and stock records were asked for. It was explained that these were fully destroyed and found to be in a torn, damaged or mutilated condition in the inner accounts office which was also not spared by the rioters.
- (d) Monthly physical stock statements sent to the bank till the date of damage were also compared with the estimate of the claim to assess the reasonableness of the claim.

20.51 Advanced Auditing and Professional Ethics

- (e) In respect of the 'A' category items (top 70% in value), investigator derived the quantities of items of closing stock using the last audited physical verification stock sheet as the starting point and adjusting subsequent receipts (from statements submitted by vendors) and issues (from statements submitted to sales tax consultant).
- (f) Both the cash on hand and the stocks were tested for 'goodness of fit' in the trends seen for the relevant periods. As far as the cash balance was concerned, it was actually estimated on the basis of the average daily balance for the previous year which seemed reasonable, considering that sales during the current period were at least 12% higher. Stock value was compared with the average stock value for the last three years and fitted reasonably to the trend.
- (g) Routine statements were taken from the cashiers and the salesmen. Apparently, when the supermarket was opened the day after the riots the entire premises were found ransacked. The manager had designated the person in-charge to assess the damage in his individual department and report on its status after taking note of the physical condition and quantity of the inventory. On the basis of these reports, made informally initially, an estimate of the loss was made.

Results and findings

General symptoms did not seem to point out anything adverse or extraordinary. It seemed as if the claim was reasonable and acceptable under the circumstances. However, the investigator decided to probe further. He asked for routine, but essential information such as the list of books and records maintained and documents in use and the system of accounting in force. In addition to the analysis of historical data of cash, sales and stocks as above, the investigator even asked for assistance in gathering and preserving documents in whatever condition they appeared to be in and expressed a desire to examine each scrap of paper himself. The investigator, eventually, came across the proof. He found some torn faxes dated three days subsequent to the date of the riots! Obviously, the rioters had not come back to damage the papers. It had to be someone else who would benefit from the destruction of papers. Moreover, it had to be someone who had been the first to visit the cash department immediately after the date of the riots. The cashier, on being confronted with the faxes, confessed that in order to take advantage of the situation, he had taken out the money and destroyed all the papers in the cashier's office to make it seem as if the cash box had also been broken open and looted. He admitted that there was indeed no damage in the inner account office. This also gave him an opportunity to cover up his earlier embezzlement by destroying all the records.

How then did the investigator guess that something was wrong when all other tests did not indicate so? Partly it was his experience. He had seen a case where an income tax assessee had deliberately taken advantage of a fire in his office to destroy certain records for avoiding disconcerting tax queries. He saw a similar opportunity here for a typical cash fraud. Secondly, it was unlikely that rioters would leave 8.5 lacs in the cash box and destroy each and every document in the office. The normal psychology of any human being would be to take off with money rather than go on rampage where no material gain was likely.

Lessons to be learnt

The case study highlights:

- (a) Disaster and crisis can provide unbelievable opportunity for perpetrating frauds, and

- (b) a fraud can be very easily camouflaged and it is very easy to fall into a trap of believing what one sees.

Thus, in situations of disaster and crisis, the investigator must not fall into the trap of believing and depending only on what is apparent, unless he has eliminated every other possibility. In such situations, he can effectively adopt the principle of 'mistrust the obvious'. He should leave no stone unturned and satisfy himself that all evidence is reliable and, if not, must clearly state in his report the extent of gap or insufficiency in the evidence. The management must be informed of all possible consequences of damage/ loss through such gaps in the evidence.

III. Misuse of a Discount Scheme

This is a case study highlighting the use of the technique of "Investigator's Bluff" to detect misuse of a discount scheme.

Introduction

Investigation goes beyond a mere exercise of examining books and records produced before an investigator. Application of skill and expertise by the investigator is essential to get meaningful and useful results. In this context, inspection, physical verification, or visit to place of manufacturing, trading, marketing or any other place of activity assumes immeasurable importance in collection and gathering of evidence. The following case study highlights the importance of inspection and use of the technique of "Investigator's Bluff".

Facts of the case

A trading concern, dealing in chocolates and sweets and having a chain of retail outlets in all the metro cities, decided to have an incentive scheme to induce shoppers to visit its shops again. The scheme required shoppers to make a purchase of more than ₹ 1,000 to entitle them to get a 10% discount coupon for their next visit. A placard was prominently displayed at each of the shops to advertise the discount scheme. Appropriate internal controls in the form of pre-numbered receipt books and discount coupons were also introduced.

Pursuant to the scheme, sales of all the metros, showed an upswing as expected, except in one city where even after the introduction of the discount scheme, the sales had not increased, though large values of discounts had been availed of the management was intrigued by this and appointed an investigator to look into the matter.

Investigator's approach and plan

The investigator's plan covered examination of the following:

- ◆ Sales
- ◆ Purchases
- ◆ Cash and bank transactions
- ◆ Salaries
- ◆ Journal entries
- ◆ Other books of account

Results and findings

The investigator did not notice anything untoward and the financial statements and the books of account seemed to be in order. The serial numbers controls, cash totals and cash registers appeared to be satisfactory. The investigator then decided to personally visit the concerned metro to look into the matter.

On a personal visit, the first thing he noticed was that the placard regarding the scheme was not displayed. Obviously, shoppers could have had no other way of knowing whether such a scheme was in force unless the cashier was, as a matter of routine, informing shoppers purchasing chocolates worth ₹ 1,000 or more, of the discount entitlement and furnishing discount coupons. He went through all the past discount coupons encashed by customers and found that most of the shoppers who had purchased chocolates and sweets over ₹ 1,000/- had purchased chocolates or sweets worth much more on their next visit. This perhaps was understandable, but even more intriguing was the fact that a lot of shoppers had visited the shop again on the same or the very next day to purchase chocolates. This was certainly unusual because normally chocolates are not 'stocked and a shopper would generally buy his required quantity on the first visit itself. This led the investigator to believe that the discounts claimed were not genuine. However, since the names and addresses of the shoppers were not available, proving any foul play was difficult.

The investigator decided to adopt "Investigator's bluff" technique. He decided to test the scheme by sending a decoy customer who purchased chocolates worth ₹ 2,500. As expected, the customer did not get the discount coupon. He was given a receipt of ₹ 2,500, numbered 20026. The spaces relating to information of discount coupon as well as the net payment amount were left blank in the receipt. At the end of the day, the cashier reported his total cash sales for the day and a statement of account coupons issued, which showed that discount coupon number 2113 had been issued against the receipt 20026. The investigator confronted the cashier about the discount coupon, who confessed that he had fraudulently retained the discount coupon himself, explained how he went about encashing such discount coupons, as follows

Step 1: Receipt say 20001 was issued to XYZ for ₹ 2,500/-

Step 2: Daily Cash Receipt and Discount Coupons Statement would disclose: A discount coupon say 2001 issued to the shopper XYZ against Receipt 20001, though the discount coupon 2001 was actually in possession of the cashier himself.

Step 3: When another customer making a purchase of ₹1,500/- did not ask for a cash receipt, the cashier would make out a receipt for ₹ 1,500/ with ₹ 150/- entered in the discount column, and attach coupon 2001 to that receipt as if that customer was XYZ who had returned to purchase chocolates again with the discount receipt 2001.

Step 4: The cashier would pocket ₹ 150/- and put ₹ 1,350/- In the cash box.

In this manner, he had siphoned off an average of almost ₹ 20,000 per week. This would never have come to light if the investigator had not visited the shop and learnt that the discount scheme, in fact, had never been in operation at all. This explained why the sales at the concerned metro had not increased even after the introduction of the scheme.

Lessons to be learnt

Very often the conventional procedures applied by the investigator do disclose weaknesses in controls and anomalies in findings. However, these procedures may, at times, fail to discover or bring to light the actual damage done and the nature of deceit or trickery. It is, therefore, essential for an investigator to adopt effective fact-finding techniques to determine whether all policies and control procedures are being implemented or not. That is also why personal inspection, visits and 'walk-through tests' are very meaningful, and where situation so demands, an "investigator's bluff", as shown above, can be used.

IV. Duplicate Documentary Evidence used to Raise False Claims

This is a case study wherein duplicate documentary evidence used to support a payment was detected by an investigator.

Introduction

In spite of various controls in an organisation, it is difficult to rule out the possibility of a payment being made on the basis of duplicate supporting evidence. It is not easy to lay down a plan applicable in all situations regarding the steps to be taken to prevent such payments. The following case study illustrates this point.

Facts of the case

A Company was spending several lacs of rupees on advertising through hoardings at prominent places in the city. The usual evidence of such an expenditure was in the form of:

- ◆ Agreement with the owner of the hoarding site, specifying the details of the size of the hoarding, the subject matter with a description of the hoarding, location, rate, and the period for which the hoarding was to be kept.
- ◆ Agreement regarding the maintenance of the hoarding, i.e., touching-up and cleaning periodically for removal of dust, erasures due to rain, etc.
- ◆ Photograph of the hoarding.
- ◆ Bill for rent charged by the owner of the site.
- ◆ Certification by an independent agency as regards verification and compliance of the terms and conditions of the agreement with the owner of the hoarding site.

Investigator's approach and plan

1. Compliance with agreement: The investigator verified the compliance of the terms of agreements, as per the checklist prepared by him.
2. Vouching of bills: The bill for rent charged by the site owner was checked to ensure that it was supported by a 'physical inspection report' and photographs.

Results and findings

At a first glance, the evidence stated above appeared to be sufficient. There was nothing in the inspection report to suggest any non-compliance of any of the terms of the agreement. However, one small detail in the photograph attached to the bill caught the investigator's attention. The photograph showed the hoarding next to a small poster of a film running at a particular cinema hall. He knew that particular cinema hall had been demolished well over a year ago. Just to satisfy himself, the investigator asked for the previous year's file and on examining it he found that the photographs of the

20.55 Advanced Auditing and Professional Ethics

hoardings attached were duplicates of those in the previous year. The investigator notified the management and suggested that a physical verification be carried out immediately to ascertain whether the hoarding was satisfactorily displayed at the site. An independent check was carried out and the results were startling. Not only had the company's hoarding been removed from its designated place on the date of verification, but its competitor was given the hoarding site for which the rent was being collected from the company. On making further inquiries with local residents, it was learnt that the hoarding of the company had been removed many months ago. The company took legal action against the owner of the hoarding site and the agency, which was responsible for carrying out the physical inspection.

Lessons to be learnt

It is necessary to minutely examine the evidence particularly where the investigator is dependent on another agency for physical inspection or verification. In this case though there was no real necessity for the investigator to call for the previous year's records, yet, on a suspicion as mentioned above, he called for the previous year's photographs and a comparison provided the clue as to the possibility of existence of a foul play. Keen examination of photographs revealed that they were identical and thus, the investigator decided to launch a further inquiry and on physical inspection at the site, the actual fraud came to light. Therefore, it is advisable that, in all areas requiring physical verification or inspection, the investigators must include in their checklist, comparison with previous periods' records. For example:

1. Physical verification of investments and comparison with investments which existed in the previous period will disclose bonus shares received or investments stolen or lost.
2. Stock verification statements compared with those related to previous period will indicate the comparative status of old, damaged, unserviceable and obsolete stocks.
3. Similar procedures will be applicable to all assets of the-client lying with third parties.
4. Physical verification or inspection is also likely to enable an investigator to verify the reasonableness and sanctity of expenses incurred.

21.1 Introduction

The term "peer" means a person of similar standing. The term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review "Peer Review" means an examination and review of the systems and procedures to determine whether they have been put in place by the practice unit for ensuring the quality of assurance services as envisaged and implied/mandated by the Technical Standards, Ethical Standards and Professional Standards and whether these were effective or not during the period under review".



Fig. : Peer Review*

The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practising individually or as a firm of Chartered Accountants.

21.2 Objectives of Peer Review

The main objective of Peer Review is to ensure that in carrying out the assurance service assignments, the members of the Institute-

- (a) comply with Technical, Professional and Ethical Standards as applicable including other regulatory requirements thereto and

* Source : cccpa.com

21.2 Advanced Auditing and Professional Ethics

- (b) have in place proper systems including documentation thereof, to amply demonstrate the quality of the assurance services.

Thus the primary objective of peer review is not to find out deficiencies but to improve the quality of services rendered by members of the profession. The Statement of Peer Review also makes it clear that the peer review, "does not seek to redefine the scope and authority of the Technical Standards specified by the Council but seeks to enforce them within the parameters prescribed by the Technical Standards". The peer review is directed towards maintenance as well as enhancement of quality of assurance services and to provide guidance to members to improve their performance and adherence to various statutory and other regulatory requirements. Such an objective of the peer review process makes it amply clear that the reviewer is not going to sit on the judgement of the *practice unit* while rendering assurance services but to evaluate the procedure followed by the practice unit in rendering such a service. Accordingly, where a practice unit is not following technical standards, the reviewers are expected to recommend measures to improve the procedures. To elaborate further, the key objective of peer review exercise is not to identify isolated cases of engagement failure, but to identify weaknesses that are pervasive and chronic in nature. For instance, absence of formal planning of an audit represents a serious deficiency that needs to be remedied by the practice unit. An instance of the auditor not carrying out physical verification of furniture and fixture may not attract the same comment. However, certain items of assets are best verified through the physical verification process and not adopting the same procedure may rightly be viewed as a systemic failure. The conclusion, therefore, is that the peer review seeks to identify and address patterns of non-compliance with quality control standards.

21.3 Scope of Peer Review

The Statement on Peer Review lays down the scope of review to be conducted as under:

The Peer Review process shall apply to all the assurance services provided by a Practice Unit.

1. Once a Practice Unit is selected for Review, its assurance engagement records pertaining to the Peer Review Period shall be subjected to Review.
2. The Review shall cover:
 - (i) Compliance with Technical, Professional and Ethical Standards:
 - (ii) Quality of reporting.
 - (iii) Systems and procedures for carrying out assurance services.
 - (iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
 - (v) Compliance with directions and / or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.

- (vi) Compliance with directions and / or guidelines issued by the Council in relating to article assistants and / or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.

As it is clear from the above, that the Statement of Peer Review aims to confine the scope of review to preceding three years since this would establish the consistency or deviations, if any, in respect of procedures followed by the practice unit. A *Practice Unit* means members in practice, whether practicing individually or a firm of Chartered Accountants.

The Statement defines the scope of peer review which revolves around compliance with technical, ethical and professional standards; quality of reporting; office systems and procedures with regard to compliance of assurance engagements; and, training programmes for staff including article and audit assistants involved in assurance engagements. The entire peer review process is directed at the assurance services. Assurance Services means assurance engagements services as specified in the “Framework for Assurance Engagements” issued by the Institute of Chartered Accountants of India and as may be amended from time to time

As per the Statement, **Technical, Professional and Ethical Standards** - means

- (i) Accounting Standards issued by ICAI and /or prescribed and notified by the Central Government of India;
- (ii) Standards issued by the Institute of Chartered Accountants of India including-
 - (a) Engagement standards
 - (b) Statements
 - (c) Guidance notes
 - (d) Standards on Internal Audit
 - (e) Statements on Quality Control
 - (f) Notifications / Directions / Announcements / Guidelines / Pronouncements / Professional standards issued from time to time by the Council or any of its committees.
- (iii) Framework for the Preparation and presentation of financial statements, framework of statements and Standard on Auditing, Standard on Assurance Engagements, Standards on Quality Control and Guidance Notes on related services issued, from time to time, by the Institute of Chartered Accountants of India and framework for assurance engagements;
- (iv) Provisions of the various relevant statutes and / or regulations which are applicable in the context of the specific engagements being Reviewed including instructions, guidelines, notifications, directions issued by regulatory bodies as covered in the scope of assurance engagements.

Students may note that assurance services shall not include:

- (i) Management Consultancy Engagements;

21.4 Advanced Auditing and Professional Ethics

- (ii) Representation before various Authorities;
- (iii) Engagements to prepare tax returns or advising clients in taxation matters;
- (iv) Engagements for the compilation of financial statements;
- (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
- (vi) Testifying as an expert witness;
- (vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and
- (viii) Engagement for Due diligence.

The phrase 'Assurance Services' is used interchangeably with Audit Services, Attestation Functions, and Audit Functions.

21.4 Applicability

Practice Units subject to Review

1. Every Practice Unit, based on their category as determined below will be subject to Peer Review in accordance with this statement.

Level I

A Practice Unit which has undertaken any of the under-mentioned assurance services in the period under review:

- (i) Central Statutory Audit of Public Sector Banks, Private Sector Banks, Foreign Banks, Cooperative Banks and Public Financial Institutions;
- (ii) Central Statutory Audit of Central or State Public Sector Undertakings and Central Cooperative Societies based on criteria such as turnover or paid up capital etc. as may be decided by the Board;
- (iii) Central Statutory Audit of Insurance Companies;
- (iv) Statutory Audit of asset management companies or mutual funds;
- (v) Statutory Audit of enterprises whose equity or debt securities are listed in India or abroad;
- (vi) Statutory Audit of Entities which have raised funds from public or banks or financial institutions of over Rupees Fifty Crores during the period under Review;
- (vii) Statutory Audit of Entities which have raised donations and / or contributions over Rupees Fifty Crores during the period under Review;
- (viii) Statutory Audit of entities having Net Worth of more than Rupees Five Hundred Crores at any time during the period under Review;

- (ix) Statutory Audit of entities which have been funded by Central and / or State Government(s) schemes of over Rupees Fifty Crores during the period under Review.

Level II

A Practice Unit which has undertaken any of the under-mentioned assurance services in the period under review:

- (i) Statutory/Internal/Concurrent/Systems/Tax audit and/or Departmental Review of Branches/Offices of
 - (a) Public Sector or Private Sector and / or Foreign Banks;
 - (b) Insurance Companies;
 - (c) Co-operative Banks;
 - (d) Statutory Audit of Regional Rural Banks;
 - (e) Statutory Audit of Non – Banking Financial Companies (NBFCs).
- (ii) Statutory Audit of entities having Net Worth of over Rs. Five Crores or an annual turnover of more than Rs. Fifty Crores during the period under Review.

Level III

Any other Practice Unit providing assurance services not covered in Level I and Level II hereinabove.

- 2. Any Practice Unit not selected for Peer Review, may suo moto apply to the Board for the conduct of its Peer Review. The Board shall act upon the same within 30 days from the date of receipt of such request.
- 3. An Auditee (Client) may request the Board for the conduct of Peer Review of its auditor (Practice Unit). The Board shall act upon the same within 30 days from the date of receipt of such request.

Periodicity of Peer Review

The Periodicity of Peer Review will be:

- (a) Level - I Practice Units – Once in 3 years.
- (b) Level - II Practice Units – Once in 4 years
- (c) Level - III Practice Units – Once in 5 Years

However, if the Board so decides or otherwise at the request of the Practice Unit, the Peer Review for a Practice Unit can be conducted at shorter intervals.

21.5 Peer Review Board

The Board shall be constituted by the Council. The Board shall consist of a maximum of twelve members to be appointed by the Council, of whom not less than 50% shall be from amongst the members of the Council as defined in Section 9 of the Chartered Accountants Act, 1949, as amended from time to time. The Council may nominate members to the Board from outside bodies and from amongst prominent individuals of high integrity and reputation, including but not limited to, regulatory authorities, bankers, academicians economists, legal Professionals and business executives. The Council shall appoint the Chairman and the Vice-Chairman from amongst its elected Council members appointed on the Board. The term of a member shall be for one year, or such other period as may be prescribed by the Council from time to time. Casual vacancies on the Board shall be filled by the Council. A Member of the Disciplinary Committee or the Disciplinary Board or the Committee on Ethical Standards or the Committee on Financial Reporting and Review Board of the Institute of Chartered Accountants of India shall not be a member of the Board.

21.5.1 Eligibility to be a Reviewer

1. A Peer Reviewer shall: -
 - (a) Be a member with at least 10 years of experience in practice.
 - (b) Is in Practice as per the Chartered Accountants Act, 1949.
 - (c) Should have undergone the requisite training as prescribed by the Board.
 - (d) Should furnish a declaration as prescribed by the Board, at the time of acceptance of Peer Review appointment.
 - (e) Should have signed the Declaration of Confidentiality as prescribed by the Board.
 - (f) Should have conducted audit of Level I Entities for at least 7 years to be eligible for conducting Peer Review of Level I Entities as referred to in Para II of this Statement.
2. For being a Reviewer a member should not have: -
 - (i) Disciplinary action / proceedings pending against him
 - (ii) been found guilty by the Council or the Disciplinary Board or Committee at any time.
 - (iii) been convicted by a Competent Court whether within or outside India, of an offence involving moral turpitude and punishable with transportation or imprisonment.
 - (iv) any Obligation or conflict of interest in the Practice Unit or its Partners / Personnel.
3. A Reviewer shall not accept any professional assignment from the Practice Unit for a period two years from the date of appointment.

21.6 The Peer Review Process

The Peer Review process will include-

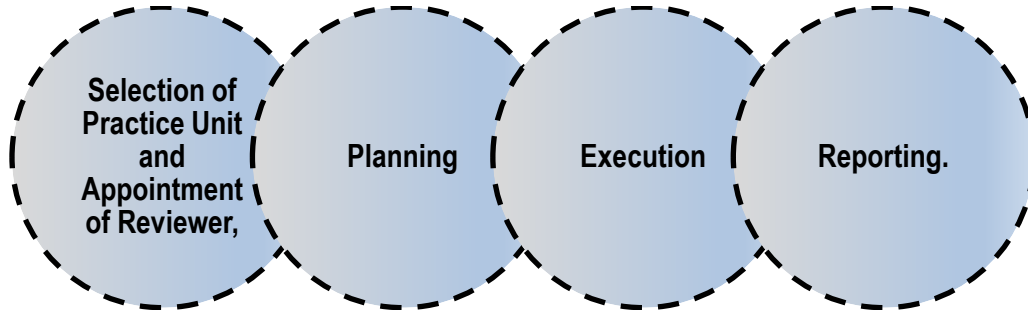


Image showing Peer Review Process

1. Selection of Practice Unit & appointment of Reviewer:

- (i) Notification to the Practice Unit:
A Practice Unit which has been selected for a Peer Review shall be notified by the Board.
- (ii) Name of three Reviewers shall be recommended by the Board to the Practice Unit so selected.
- (iii) The Practice Unit shall select one out of the three Reviewers & intimate to the Board within seven days of receipt of the names.
- (iv) The Board shall intimate the Reviewer so selected and seek his consent within seven days.

2. Planning:

- (i) Information to be furnished by Practice Unit
On intimation by the Board, of the Reviewer's consent, the Practice Unit shall within 15 days furnish the following information to the Reviewer:
 - Duly filled-in Questionnaire sent by the Board.
 - Complete list of assurance service clients indicating the nature of service provided and the fees charged for the period under Review.
 - A note on the policies and procedures adopted by the Practice Unit in relation to Independence, Staff Supervision and Development, 'Second Person' Review and the process generally followed in carrying out assurance services.
 - Details of any proceedings against the Practice Unit or any of its partners or qualified assistants taken by any regulatory, monitoring or enforcement bodies relating to investigation or allegation of deficiency in the conduct of Attest function by them during the period of three years preceding the period of Review or at any time thereafter i.e. till the date of submission of the duly filled-in Questionnaire.

21.8 Advanced Auditing and Professional Ethics

- (ii) Selection of Sample by the Reviewer:
 - (a) The Reviewer shall within 15 days of receiving the information from the Practice Unit select a sample of the assurance services that he would like to Review and intimate the same to the Practice Unit.
 - (b) The Reviewer may also seek further / additional clarification from the Practice Unit on the information furnished / not furnished.
 - (c) The Reviewer shall plan for an on-site Review visit or initial meeting in consultation with the Practice Unit. The Reviewer shall give the Practice Unit at least fifteen days time to keep ready the necessary records of the selected assurance services.
 - (d) The Reviewer and Practice Unit shall mutually cooperate and ensure that the entire Review process is completed within 90 days from the date of notifying the Practice Unit about its selection for Review.

3. Execution:

- (i) Peer Review visits will be conducted at the Practice Unit's head office or /and branch(es) or any other locations. This on-site Review should not extend beyond seven working days.
- (ii) Compliance Review-General Controls
 - (a) The Reviewer is required to carry out a compliance Review of the following General Controls for evaluating the degree of reliance to be placed upon them for effective Review:
 - ◆ Independence
 - ◆ Maintenance of Professional Skills and Standards
 - ◆ Outside Consultation
 - ◆ Staff recruitment, Supervision and Development
 - ◆ Office Administration
- (iii) Selection of Assurance Service Engagements for Review
 - (a) The number of assurance service engagements to be Reviewed shall depend upon:
 - ◆ Standard of quality controls generally prevailing;
 - ◆ The size and nature of assurance service engagements undertaken by the Practice Unit.
 - ◆ The methodology generally adopted by the Practice Unit in providing assurance services.
 - ◆ The number of partners / members involved in assurance service engagements in the Practice Unit;

- ◆ The number of locations / branch offices of the practice Unit;
 - ◆ The Fees charged / received / service tax paid by the Practice unit.
- (b) From the initial sample selected at the planning stage, the Reviewer, in consultation with the Practice Unit, may reduce or enlarge the initial sample size of assurance service engagements for Review.
- (iv) Review of Records

The Reviewer is required to adopt a combination of compliance approach and substantive approach in the Review process.

(A) Compliance Approach – Assurance Service Engagements

The compliance approach is to assess whether proper control procedures have been established / followed by the Practice Unit to ensure that assurance services are being performed in accordance with Technical, Professional and Ethical Standards.

The following areas shall be considered:

- ◆ Assurance services records for Administration
- ◆ Review and Evaluation of System of Internal controls
- ◆ Substantive Tests
- ◆ Financial Statements Presentation and
- ◆ Assurance Services Conclusions
- ◆ Assurance Services Reporting

(B) Substantive Approach - Assurance Service Engagements

This approach requires a Review of the assurance working papers in order to establish the extent of compliance, whether the assurance work has been carried out as per the Technical, Ethical, and Professional Standards.

4. Reporting:

The Peer Review Report should state that the system of quality control for the assurance services of the Practice Unit for the period under Review has been designed so as to carry out the assurance services in a manner that ensures compliance with Technical, Professional and Ethical standards.

The Peer Review Report shall address his report of compliance or otherwise on the following areas of controls:

- (a) Independence
- (b) Maintenance of Professional skills and standards.
- (c) Outside Consultation
- (d) Staff recruitment, Supervision and Development.

21.10 Advanced Auditing and Professional Ethics

- (e) Office Administration.
 - (i) Discussion/Communication of Findings
 - (a) After completing the on-site Review, the Reviewer, before making his Report to the Board, shall communicate his findings in the Preliminary Report to the Practice Unit if in his opinion, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification.
 - (b) The Practice Unit shall within 15 days after the date of receipt of the findings, make any submissions or representations, in writing to the Reviewer. (i.e. Response to the Preliminary Report).
 - (ii) Peer Review Report of Reviewer
 - (a) At the end of an on-site Review if the Reviewer is satisfied with the reply received from the Practice Unit, he shall submit a Peer Review Report to the Board along with his initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.
 - (b) In case the Reviewer is of the opinion that the response by the Practice Unit is not satisfactory, the Reviewer shall accordingly submit a modified Report to the Board incorporating his reasons for the same. The Reviewer shall also submit initial findings (i.e. Preliminary Report), response by the Practice Unit (Response to Preliminary Report) and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.
 - (c) In case of a modified report, The Board shall order for a "Follow On" Review after a period of one year from the date of issue of report as mentioned in (b) above. If the Board so decides, the period of one year may be reduced but shall not be less than six months from the date of issue of the report.

21.6.1 Qualified Assistant

The reviewer may take the help of a qualified assistant while carrying out peer review. In this context, the Board decided to clarify that a reviewer is permitted to take the assistance of only one assistant who shall be a chartered accountant and a person who does not attract any of the dis-qualifications prescribed under Section 8 or Section 21 of the Chartered Accountants Act, 1949. The name of the qualified assistant which the reviewer would like to assist him shall be identified and intimated to the Board as well as the practice unit before the commencement of the peer review. Such a qualified assistant shall also have to sign the declaration of confidentiality as annexed to the Statement. He shall have no direct interface either with the

practice unit or the Board. Further the person chosen for assisting the reviewer shall be from the firm of the reviewer and should have been working with him for at least one year as a member in practice.

21.6.2 Confidentiality

Strict confidentiality shall be maintained by all those involved in the Peer Review process, namely, Reviewers, members of the Board, any-Qualified Assistants or Practice Unit.

All persons governed by the secrecy provisions:

- (a) shall at all times preserve and aid in preserving secrecy with regard to any matter arising in the performance or in assisting in the performance of any function, directly or indirectly related to the process and conduct of Peer Reviews;
- (b) Reviewer shall not make use of or disclose the contents of Review report or any confidential information about the process of Review unless as required by the Board or the Council.

Non-compliance with the secrecy provisions in the above clause shall amount to professional misconduct as defined under Section 22 of the Chartered Accountants Act, 1949.

A Declaration of Confidentiality shall be signed by the persons who are responsible for the conduct of Peer Review i.e., Reviewers, and his Qualified Assistants and be filed with the Board. All members of the Board shall also sign a declaration of Confidentiality in a manner as may be prescribed by the Board.

21.6.3 Approach of the Reviewer

Briefly, the stepwise approach which may be adopted by the reviewer is discussed in the following paragraphs:

- (a) The reviewer should gain an understanding of the engagement letter since an assurance engagement or for that matter any other kind of engagement should begin with an engagement letter. Engagement letter is an important document as it defines the nature and scope of the assurance engagement, practice unit's responsibilities with regard to the engagement. This understanding would help him in planning the review of documentation. The reviewer should focus the review primarily on the key engagement matters. The reviewer should also consider the materiality of the matter while planning the review.
- (b) The number of assurance engagements to be selected requires the exercise of judgement by the reviewer based on the evaluation of replies given in the questionnaire and the size of the practice unit. The objective is to obtain a reasonable cross-section of the practice unit's clients although greater weight may be given to large clients.
- (c) The practice unit may have policies and procedures for accepting a particular engagement. These policies and procedures may not exist in the form of records in each practice unit. In such a case the reviewer should consider enquiring from the concerned persons about such policies and procedures. The reviewer should, wherever possible,

21.12 Advanced Auditing and Professional Ethics

examine that the policies and procedures for acceptance of audit have been complied with and necessary documentation with regard to the same exists.

- (d) The reviewer may follow a combination of compliance procedures and substantive procedures throughout the peer review process. The mix of compliance and substantive procedures depends upon the professional judgement of the reviewer. The reviewer may consider the following:
- In carrying out the compliance tests, the reviewer may evaluate whether the policies and procedures of the practice unit are sufficient to ensure compliance of technical standards and whether these policies and procedures are adequately communicated to all staff who are involved in carrying out the assurance work.
 - In performing substantive tests, the reviewer should evaluate whether the practice unit's working papers relating to the client adequately document the findings and conclusions and whether the report of practice unit is in consonance with the findings and conclusions drawn.
- (e) Finally, the reviewer while evaluating records may consider the following:
- determine that any significant issues, matters, problems that arose during the course of the engagement have been appropriately considered, resolved and documented;
 - determine that adequate audit evidence or other relevant evidence in relation to the engagement is obtained to support the reasonableness of the conclusions drawn; and
 - determine that significant decisions relating to the engagement, use of professional judgement, resolution of significant matters have been properly documented.

21.6.4 Inherent Limitations of Review

The reviewer conducts the review in accordance with the Statement on Peer Review. The review would not necessarily disclose all weaknesses in compliance of technical standards and maintenance of quality of assurance services since it would be based on selective tests. As there are inherent limitations in the effectiveness of any system of quality control which happens to be subject-matter of review, departure from the system may occur and may not be detected.

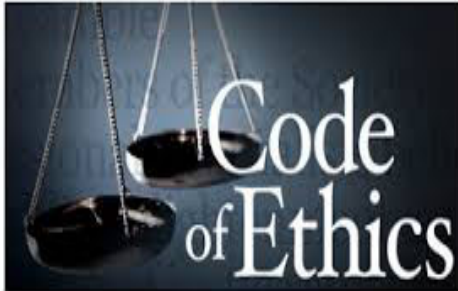
Professional Ethics

22.1 Introduction

The term “*Ethics*” means moral principles which govern a person’s behaviour or the conducting of an activity. It is the branch of knowledge that deals with moral principles, whereas “*Professional Ethics*” consist of personal, organizational and corporate standards of behaviour expected for professionals. Every professional has some enforced code of ethics which need to be followed to preserve the integrity of the profession. However, there is a dispute with regard to whether profession should be consistent with the requirements of morality governing public. This can be understood with some of the examples, like, a doctor lies to a patient about the serious condition of his health, thinking that disclosing the seriousness of health may cause more distress to the patient. This would be morally wrong as the doctor is hiding imperative information from the patient. However, here, improvement in health is given moral priority and hence it is justifiable to contravene other morals. Another example would be on the practice of lawyer. A lawyer is responsible to his immediate client only. It doesn’t matter whether the client has committed an offence or not, the lawyer has to defend him before the court of law, whereas a Chartered Accountant, as an auditor, has the responsibility to highlight and bring to the knowledge of stakeholders about where the client has flawed. This implies that there can be different moral codes to different sections of society or professionals.

Chartered Accountants as professionals are engaged in building trust to vast variety of users, whether shareholders, government, banks, investors, employees or others, which imposes a public interest responsibility on their profession. Like other professionals, Chartered Accountants also have some set of code of ethics. A Chartered Accountant, either in practice or in service, has to abide by these ethical behaviors. They are expected to follow the fundamental principles of professional ethics while performing their jobs. Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants.

Code of Ethics– Its Necessity: Ethics are as old as human civilization. It is nothing but the laws or rules of acceptable behaviour. The whole foundation of any profession, particularly CA profession, is its credibility. The sole purpose of Code of Ethics is to ensure and uphold this credibility. The main ingredient of our profession is independence. An auditor needs to be independent while carrying out his audit. The provisions discussed in the same ensure that the independence of members of the Institute is not affected.



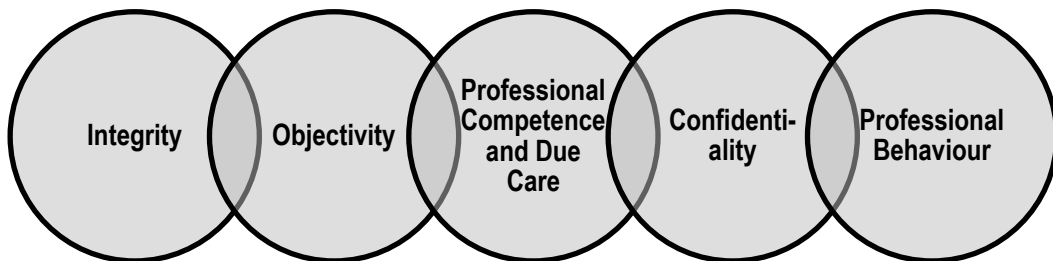
Our Institute's Motto – 'Ya Esha Supteshu Jagrati' is adopted from Kathopanishad and it denotes 'eternal vigilance' – awakening when the world is asleep.

Many of our members perceive Code of Ethics as a burden. They are totally mistaken. On the contrary Code of Ethics seeks to protect the interests of the profession as a whole. It is a shield that enables us to command respectability.

Fig. : Scale of Code of Ethics*

22.2 Fundamental Principles

In order to achieve the objectives of the Accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles as discussed in Code of Ethics of ICAI, to be complied, are given below:



Integrity - A professional accountant should be straightforward and honest in all professional and business relationships.

Objectivity - A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional judgments.

Professional Competence and Due Care - A professional accountant has a continuing duty to maintain professional knowledge based on current developments, and should act in accordance with applicable technical and professional standards while providing professional services.

Confidentiality - A professional accountant should respect the confidentiality of information acquired as a result of professional and employment relationships. The acquired information should not be disclosed to third parties without specific authority unless there is a legal or professional duty to disclose, and should also not be used for personal advantage of any person.

* Source: CSRwire

Professional Behaviour - A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

22.3 Membership of the Institute

On acceptance of application by the Council, the applicant's name shall be entered in the Register and a certificate of membership in the appropriate Form shall be issued to the applicant.

Particulars of the Register: Section 19 of the Act provides the particulars to be included in the Register about every member of the Institute, namely-

- (i) his full name, date of birth, domicile, residential and professional address;
- (ii) date on which his name is entered in the Register;
- (iii) his qualifications;
- (iv) whether he holds a certificate of practice (COP); and
- (v) any other particulars which may be prescribed.

22.3.1 Disabilities for the Purpose of Membership

Section 8 of the Chartered Accountants Act, 1949 enumerates the circumstances under which a person is debarred from having his name entered in or borne on the Register of Members, as follows:

- (i) If he has not attained the age of 21 years at the time of his application for the entry of his name in the Register; or
- (ii) If he is of unsound mind and stands so adjudged by a competent court; or
- (iii) If he is an undischarged insolvent; or
- (iv) If he, being a discharged insolvent, has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part; or
- (v) If he has been convicted by a competent Court whether within or without India, of an offence involving moral turpitude and punishable with transportation or imprisonment or of an offence, not of a technical nature, committed by him in his professional capacity unless in respect of the offence committed he has either been granted a pardon or, on an application made by him in this behalf, the Central Government has, by an order in writing, removed the disability; or
- (vi) If he has been removed from membership of the Institute on being found on inquiry to have been guilty of professional or other misconduct;

It may be noted that a person who has been removed from membership for a specified period, shall not be entitled to have his name entered in the Register until the expiry of such period.

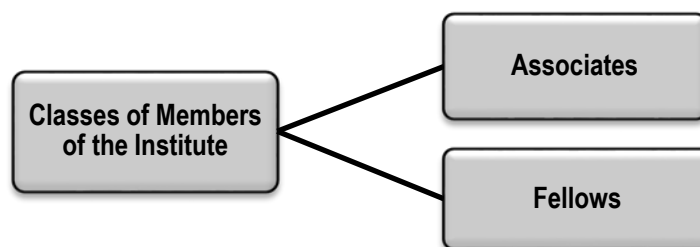
In addition, failure on the part of a person to disclose the fact that he suffers from any one of the disabilities aforementioned would constitute professional misconduct. The name of the

22.4 Advanced Auditing and Professional Ethics

person, who is found to have been subject at any time to any of the disabilities aforementioned, can be removed from the Register of Members by the Council.

22.3.2 Types of Members of the Institute

Section 5 of the Chartered Accountants Act, 1949 provides the division of members of the Institute. The members shall be divided into two classes designated as Associates and Fellows.



Diagrammatic presentation showing types of members of the Institute

Associate Member: Any person, whose name has been entered in the Register, shall be deemed to have become an Associate of the Institute and shall also be entitled to use the letters A.C.A. after his name to indicate that he is an Associate Member of the Institute.

Fellow Member: The name of following types of members shall be entered into the Register as a Fellow of the Institute, on payment of such fees along with the application made and granted in the prescribed manner-

- (i) An associate member who has been in continuous practice in India for at least 5 years,
- (ii) A member who has been an associate for a continuous period of not less than 5 years and who possesses such qualifications as may be prescribed by the Council with a view to ensuring that he has experience equivalent to the experience normally acquired as a result of continuous practice for a period of 5 years as a Chartered Accountant.

The abovementioned members shall be entitled to use the letters F.C.A. after his name to indicate that he is a Fellow Member of the Institute.

22.3.3 Removal of Name from the Register

As per section 20 of the Act, the Council may remove, from the Register, the name of any member of the Institute in the following cases-

- (i) who is dead; or
- (ii) from whom a request has been received to that effect; or
- (iii) who has not paid any prescribed fee required to be paid by him; or
- (iv) who is found to have been subject at the time when his name was entered in the Register, or who at any time thereafter has become subject, to any of the disabilities mentioned in Section 8, or who for any other reason has ceased to be entitled to have his name borne on the Register.

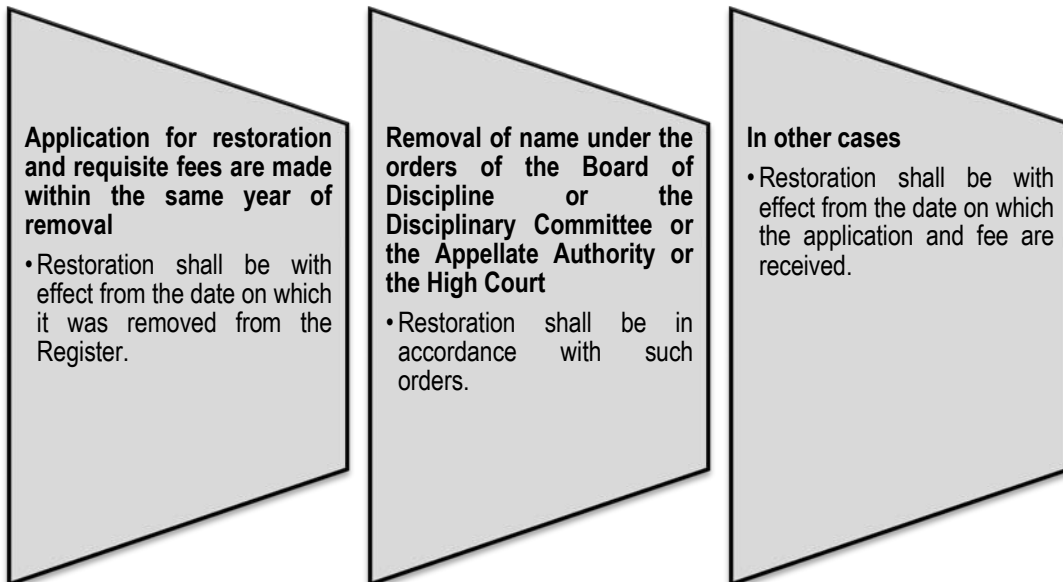
The Council shall remove the name of any member from the Register in respect of whom an order has been passed under this Act removing him from membership of the Institute.

If the name of any member has been removed from the Register for non-payment of prescribed fee as required to be paid by him, then, on receipt of an application, his name may be entered again in the Register on payment of the arrears of annual fee and entrance fee along with such additional fee, as may be determined by the Council.

22.3.4 Restoration of Membership

In addition to the provisions of the section 20 of the Chartered Accountants Act, 1949 (as discussed in above Para), Regulation 19 of the Chartered Accountants Regulations, 1988, as well states that the name of the member may be restored by the Council in the Register on an application, in the appropriate Form, received in this behalf whose name has been removed from the Register for non-payment of prescribed fee as required to be paid by him, if he is otherwise eligible to such membership, on his paying the arrears of annual membership fee, entrance fee and additional fee determined by the Council under the Act.

However, the effective date in case of restoration of cancelled membership, in different situations, shall be in the following manner:



22.3.5 Penalty for Falsely Claiming to be a Member etc.

Section 24 of the Chartered Accountants Act, 1949 provides that any person who-

- (i) not being a member of the Institute;
 - (a) represents that he is a member of the Institute; or
 - (b) uses the designation Chartered Accountant;

22.6 Advanced Auditing and Professional Ethics

- (ii) being a member of the Institute, but not having a certificate of practice, represents that he is in practice or practices as a Chartered Accountant,

shall be punishable on first conviction with fine which may extend to ₹ 1000, and on any subsequent conviction with imprisonment which may extend to 6 months or with fine which may extend to ₹ 5,000, or with both.

The provision may be understood with a case, where, the Court of Additional Chief Judicial Magistrate had by its judgement found the accused guilty under Section 24(i)(a) & (b) of the Chartered Accountants Act, 1949 and Section 465 of the Indian Penal Code. The Court imposed a fine on the accused and in the event of his failure to pay the fine, sentenced to rigorous imprisonment for three months. (Case of Prem Batra decided on 18.7.1989)

22.4 Chartered Accountants in Practice

A practicing Chartered Accountant is a person who is a member of the Institute and is holding Certificate of Practice; and includes such members of the Institute who are deemed to be in Practice in accordance with the provisions of the Chartered Accountants Act, 1949.

22.4.1 Significance of the Certificate of Practice

A member who is not in practice is precluded from accepting engagement to render services of any of the types normally prescribed for a Chartered Accountant, even though for doing so, he does not require special qualifications. The Council of the institute is of view that-

- (i) Once the person concerned becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act and its Regulations. If and when he appears before the Income-tax Tribunal as an Income-tax representative after having become a member of the Institute, he could so appear only in his capacity as a Chartered Accountant and a member of the Institute. Having, as it were, brought himself within the jurisdiction of the Chartered Accountants Act and its Regulations, he could not set them at naught by contending that even though he continues to be a member of the Institute and has been punished by suspension from practice as a member, he would be entitled, in substance, to practice in some other capacity.
- (ii) A member of the Institute can have no other capacity in which he can take up such practice, separable from his capacity to practice as a member of the Institute.”

Therefore, in nutshell, a Chartered Accountant whose name has been removed from the membership for professional and/or other misconduct, during such period of removal, will not appear before the various tax authorities or other bodies before whom he could have appeared in his capacity as a member of this Institute.

[Note: For illustrative examples/case studies on abovementioned provisions, students may refer question no. 10(a), 28(a) of the Practice Manual.]

22.4.2 Cancellation and Restoration of Certificate of Practice

Regulation 10 provides that a Certificate of Practice (COP) shall be liable for cancellation, if:

- (i) the name of the holder of the certificate is removed from the Register; or
- (ii) the Council is satisfied, after giving an opportunity of being heard to the person concerned, that such certificate was issued on the basis of incorrect, misleading or false information, or by mistake or inadvertence; or
- (iii) a member has ceased to practise; or
- (iv) a member has not paid annual fee for certificate of practice till 30th day of September of the relevant year.

Where a COP is cancelled, the holder shall surrender the same to the Secretary.

Further, Regulation 11 on restoration of COP states that, on an application made in the approved Form and on payment of such fee, the Council may restore the COP with effect from the date on which it was cancelled, to a member whose certificate has been cancelled due to non-payment of the annual fee for the COP and whose application, complete in all respects, together with the fee, is received by the Secretary before the expiry of the relevant year.

22.4.3 Members who are deemed to be in Practice

Every member of the Institute is entitled to designate himself as a Chartered Accountant. There are two classes of members, those who are in practice and those who are otherwise occupied. In Section 2(2) of the Act, the term deemed "to be in practice" has been defined as follows:

"A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, or in partnership with members of such other recognised professions as may be prescribed, he, in consideration of remuneration received or to be received-

- (i) engages himself in the practice of accountancy; or
- (ii) offers to perform or performs service involving the auditing or verification of financial transactions, books, accounts or records, or the preparation, verification or certification of financial accounting and related statements or holds himself out to the public as an accountant; or
- (iii) renders professional services or assistance in or about matters of principle or detail relating to accounting procedure or the recording, presentation or certification of financial facts or data; or
- (iv) renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice;

and the words "to be in practice" with their grammatical variations and cognate expressions shall be construed accordingly.

Explanation - An associate or a fellow of the Institute who is a salaried employee of a Chartered Accountant in practice or a firm of such Chartered Accountants or firm consisting of one or more

22.8 Advanced Auditing and Professional Ethics

chartered accountants and members of any other professional body having prescribed qualifications shall, notwithstanding such employment, be deemed to be in practice for the limited purpose of the training of Articled Assistants”.

Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of “Management Consultancy and other Services”.

The expression “Management Consultancy and other Services” shall not include the function of statutory or periodical audit, tax (both direct taxes and indirect taxes) representation or advice concerning tax matters or acting as liquidator, trustee, executor, administrator, arbitrator or receiver, but shall include the following-

- (i) Financial management planning and financial policy determination.*
- (ii) Capital structure planning and advice regarding raising finance.*
- (iii) Working capital management.*
- (iv) Preparing project reports and feasibility studies.*
- (v) Preparing cash budget, cash flow statements, profitability statements, statements of sources and application of funds etc.
- (vi) Budgeting including capital budgets and revenue budgets.
- (vii) Inventory management, material handling and storage.
- (viii) Market research and demand studies.
- (ix) Price-fixation and other management decision making.
- (x) Management accounting systems, cost control and value analysis.
- (xi) Control methods and management information and reporting.
- (xii) Personnel recruitment and selection.
- (xiii) Setting up executive incentive plans, wage incentive plans etc.
- (xiv) Management and operational audits.
- (xv) Valuation of shares and business and advice regarding amalgamation, merger and acquisition.
- (xvi) Business Policy, corporate planning, organisation development, growth and diversification.

* Consideration of “tax implications” while rendering the services at (i), (ii), (iii) and (iv) above will be considered as part of “Management Consultancy and other services”.

- (xvii) Organisation structure and behaviour, development of human resources including design and conduct of training programmes, work study, job-description, job evaluation and evaluation of workloads.
- (xviii) Systems analysis and design, and computer related services including selection of hardware and development of software in all areas of services which can otherwise be rendered by a Chartered Accountant in practice and also to carry out any other professional services relating to EDP.
- (xix) Acting as advisor or consultant to an issue, including such matters as:
 - (a) Drafting of prospectus and memorandum containing salient features of prospectus. Drafting and filing of listing agreement and completing formalities with Stock Exchanges, Registrar of Companies and SEBI.
 - (b) Preparation of publicity budget, advice regarding arrangements for selection of (i) ad-media, (ii) centres for holding conferences of brokers, investors, etc., (iii) bankers to issue, (iv) collection centres, (v) brokers to issue, (vi) underwriters and the underwriting arrangement, distribution of publicity and issue material including application form, prospectus and brochure and deciding on the quantum of issue material (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
 - (c) Advice regarding selection of various agencies connected with issue, namely Registrars to Issue, printers and advertising agencies.
 - (d) Advice on the post issue activities, e.g., follow up steps which include listing of instruments and dispatch of certificates and refunds, with the various agencies connected with the work.

Explanation - For removal of doubts, it is hereby clarified that the activities of broking, underwriting and portfolio management are not permitted.
- (xx) Investment counselling in respect of securities [as defined in the Securities Contracts (Regulation) Act, 1956 and other financial instruments.] (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
- (xxi) Acting as registrar to an issue and for transfer of shares/other securities. (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
- (xxii) Quality Audit.
- (xxiii) Environment Audit.
- (xxiv) Energy Audit.
- (xxv) Acting as Recovery Consultant in the Banking Sector.
- (xxvi) Insurance Financial Advisory Services under the Insurance Regulatory & Development Authority Act, 1999, including Insurance Brokerage.

22.10 Advanced Auditing and Professional Ethics

Pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949, read with Regulation 191 of Chartered Accountants Regulations, 1988 a member shall be deemed to be in practice if he, in his professional capacity and neither in his personal capacity nor in his capacity as an employee, acts as a liquidator, trustee, executor, administrator, arbitrator, receiver, adviser or representative for costing, financial or taxation matters or takes up an appointment made by the Central Government or a State Government or a court of law or any other legal authority or acts as a Secretary unless his employment is on a salary-cum-full-time basis.

It is necessary to note that a person is deemed to be in practice not only when he is actually engaged in the practice of accountancy but also when he offers to render accounting services whether or not he in fact does so. In other words, the act of setting up of an establishment offering to perform accounting services would tantamount to being in practice even though no client has been served.

It may also be noted that a member of the Institute is deemed to be in practice during the period he renders 'service with armed forces'.

The above provisions need to be correlated with the provisions of section 144 of the Companies Act, 2013 which prohibits an auditor of the company from rendering certain services directly or indirectly to the company or its holding company or its subsidiary company.

(Students may refer Chapter 6 'The Company Audit' of the Study Material for detailed understanding of provisions on section 144 of the Companies Act, 2013)

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 17(a), 20(a) of the Practice Manual.]

22.4.4 Companies not to Engage in Accountancy

Section 25 of the Chartered Accountants Act, 1949 provides that:

- (1) No company, whether incorporated in India or elsewhere, shall practise as chartered accountants.

Here, the term "company" shall include any limited liability partnership which has company as its partner for the purpose of this section.

- (2) If any company contravenes this provision then, without prejudice to any other proceedings which may be taken against the company, every director, manager, secretary and any other officer thereof who is knowingly a party to such contravention shall be punishable with fine which may extend on first conviction to ₹ 1,000 and on any subsequent conviction to ₹ 5,000.

In addition, as per section 141(2) of the Companies Act, 2013, where a firm (including a limited liability partnership) is appointed as an auditor of a company, then, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

On thoroughly studying the provisions of both the Acts, the LLPs, though allowed to be appointed as an auditor in accordance with the Companies Act, 2013, however, it can't be engaged into practice, if it has company as its partner, as per the Chartered Accountants Act, 1949.

Therefore, in short, the LLP not having any company as its partner, can be engaged into practicing and thus take audit assignments.

22.4.5 Member in Practice Prohibited from using a Designation Other Than Chartered Accountant

- (i) The member of the Institute are now permitted to use the word 'CA' as prefix before their name irrespective of the fact that they are in practice or not.
- (ii) Under Section 7 of the Chartered Accountants Act, 1949 a member in practice cannot use any designation other than that of a Chartered Accountant, nor can he use any other description, whether in addition thereto or in substitution therefor, but a member who is not in practice and does not use the designation of a Chartered Accountant may use any other description. Nevertheless a member in practice may use any other letters or description indicating membership of Accountancy Bodies which have been approved by the Council or of bodies other than Accountancy Institutes so long as such use does not imply adoption of a designation and/or does not amount to advertisement or publicity.

For example, though a member cannot designate himself as a Cost Accountant, he can use the letters A.I.C.W.A. after his name, when he is a member of that Institute.

“It is improper for a Chartered Accountant to state on his professional documents that he is an Income-tax Consultant, Cost Accountant, Company Secretary, Cost Consultant or a Management Consultant”.

“Member are allowed to appear before the various authorities including Company Law Board, Income Tax Appellate Tribunal, Sales Tax Tribunal where the law has permitted the same, so far as the designation “Corporate Lawyer” is concerned, the Council was of the view that as per the existing provisions of law, a Chartered Accountant in practice is not entitled to use the designation “Corporate Lawyer”.

Further, the members are not permitted to use the initials ‘CPA’ (standing for Certified Public Accountant) on their visiting cards”.

“Members of the Institute in practice who are otherwise eligible may also practice as Company Secretaries and/or Cost Accountants. Such members shall, however, not use designation/s of the aforesaid Institute/s simultaneously with the designation “Chartered Accountant”.

22.4.6 Maintenance of Branch Offices

In terms of Section 27 of the Act, if a Chartered Accountant in practice or a Firm of Chartered Accountants has more than one office in India, each one of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm to have a member in charge of its branch and a separate member in case of each of the branches, where there is more than one, would constitute professional misconduct.

However, exemption has been given to members practicing in hill areas subject to certain conditions. The conditions are:

- (1) Such members/firm be allowed to open temporary offices in a city in the plains for a limited period not exceeding 3 months in a year.

22.12 Advanced Auditing and Professional Ethics

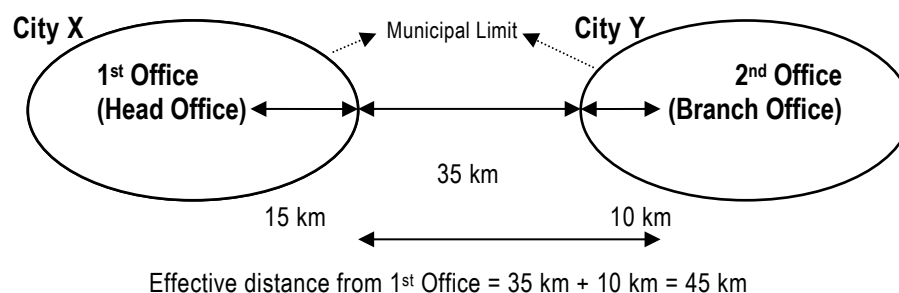
- (2) The regular office need not be closed during this period and all correspondence can continue to be made at the regular office.
- (3) The name board of the firm in the temporary office should not be displayed at times other than the period such office is permitted to function as above.
- (4) The temporary office should not be mentioned in the letterheads, visiting cards or any other documents as a place of business of the member/firm.
- (5) Before commencement of every winter it shall be obligatory on the member/firm to inform the Institute that he/it is opening the temporary office from a particular date and after the office is closed at the expiry of the period of permission, an intimation to that effect should also be sent to the office of the Institute by registered post.

It is necessary to mention that the Chartered Accountant in-charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him.

However, a member can be in-charge of two offices if they are located in one and the same Accommodation. In this context some of the Council's decisions are as follows:

- (1) With regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of Chartered Accountant, provided it is a name-plate or a name-board of an individual member and not of the firm.
- (2) The exemption may be granted to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided-
 - (a) the second office is located in the same premises, in which the first office is located or,
 - (b) the second office is located in the same city, in which the first office is located or,

- (c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located.



A member having two offices of the type referred to above shall have to declare, which of the two offices is his main office, which would constitute his professional address.

[Note: For illustrative examples/case studies on abovementioned provisions, students may refer question no. 9(i), 17(b), 30(b) of the Practice Manual.]

22.4.7 KYC Norms for CA in Practice

The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI recommended such norms to be observed by the members of the profession who are in practice. These Know Your Client (KYC) Norms are also important in order to ensure a healthy growth of the profession and an equitable flow of professional work among the members.

The self-regulatory measures are recommendatory. However, considering the spirit underlying these measures, it is expected that every Chartered Accountant carrying out attest function is encouraged to follow them and implementation of these measures would go a long way in ensuring equitable flow of work among the members and would also further enhance the prestige of the profession in the society.

The KYC Norms approved by the Council of ICAI are given below:

- 1. Where Client is an Individual/ Proprietor**
 - A. General Information
 - B. Engagement Information
- 2. Where Client is a Corporate Entity**
 - A. General Information
 - B. Engagement Information
 - C. Regulatory Information
- 3. Where Client is a Non-Corporate Entity**
 - A. General Information
 - B. Engagement Information

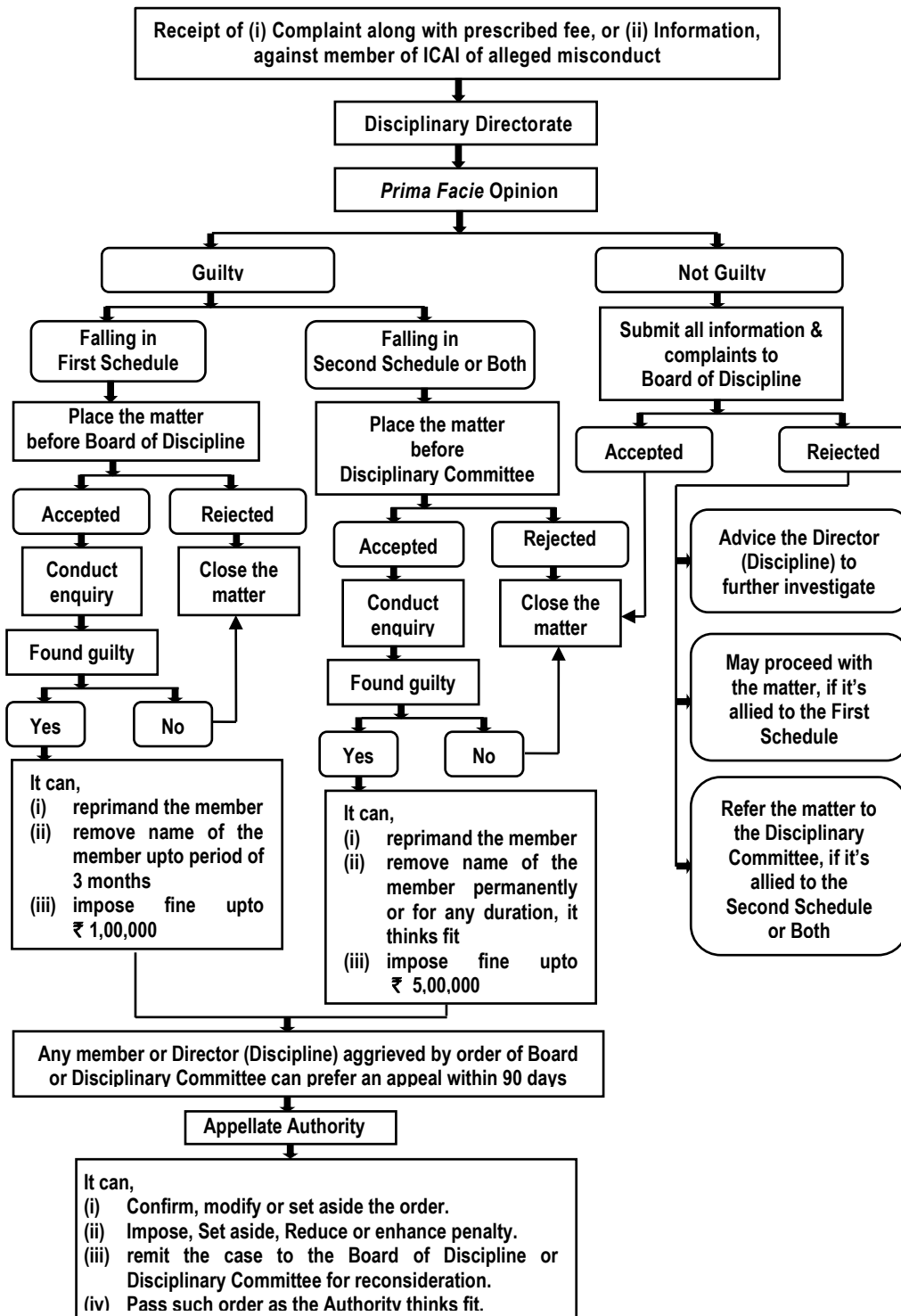
22.5 Chartered Accountants in Service

In accordance with the definitions provided under the Code of Ethics, a Professional Accountant in Service or Chartered Accountant in Service means a professional accountant employed or engaged in an executive or non-executive capacity in such areas as commerce, industry, service, the public sector, education, the not for profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities.

22.6 Disciplinary Procedure

Provisions of the Chartered Accountant, Act, 1949 regarding (i) Disciplinary Directorate, (ii) Board of Discipline, (iii) Disciplinary Committee, (iv) Appellate Authority and procedure in enquiries for disciplinary matters relating to misconduct of the members of the Institute are as hereunder:

Flow Chart of Discipline Procedure Mechanism



[For detailed knowledge with respect to Disciplinary Procedure, students are advised to refer Chartered Accountants Act, 1949 produced under Annexure 2 at the end of this Chapter.]

22.7 Types of Misconduct- Professional or Other

According to section 22 of the Act, for the purposes of this Act, the expression “professional or other misconduct” shall be deemed to include any act or omission provided in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of section 21 to inquire into the conduct of any member of the Institute under any other circumstances.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any Professional or Other Misconduct.

22.7.1 Professional Misconduct: Professional misconduct has been defined in part I, II and III of the First Schedule; and part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his action in accordance with the provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the Schedule, he/she shall be deemed to be guilty of professional misconduct.

22.7.2 Other Misconduct: Other misconduct has been defined in part IV of the First Schedule and part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty.

Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity. [See section 8(v) of the Act].

Some illustrative examples, where a member may be found guilty of “Other Misconduct”, under the aforesaid provisions rendering, himself unfit to be member are:

- (i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
- (ii) Where a chartered accountant makes a material misrepresentation.
- (iii) Where a chartered accountant uses the services of his articled or audit assistant for purposes other than professional practice.
- (iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act 1949.
- (v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

22.16 Advanced Auditing and Professional Ethics

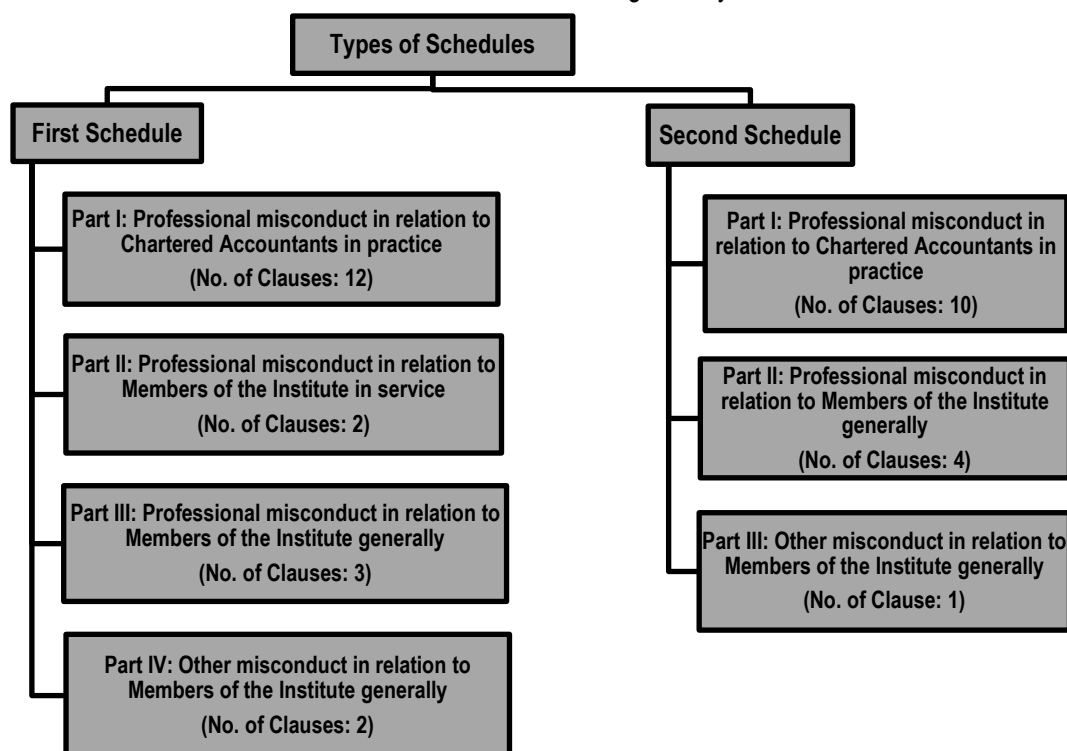
- (vi) Not replying within a reasonable time and without a good cause to the letter of the public authorities.
- (vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed-room of the chartered accountant.
- (viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.

[Note: For illustrative examples/case studies on abovementioned provisions, students may refer question no. 10(b) of the Practice Manual.]

22.8 Schedules to the Act

Acts or omissions which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule. The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services. Part III deals with the misconduct of members generally and Part IV deals with other misconduct in relation to members of the institute generally.

The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and Part III deals with other misconduct in relation to members of the Institute generally.



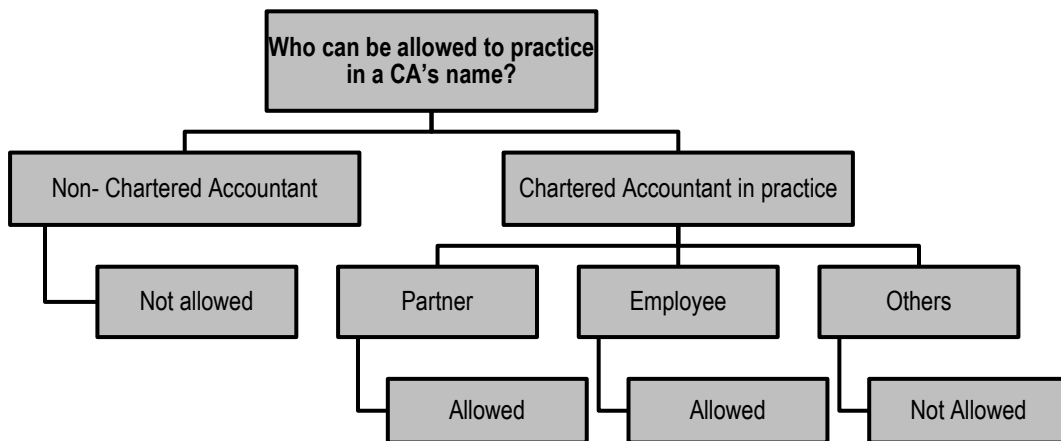
The implications of the different clauses in the schedules are discussed below:

22.8.1 The First Schedule: Where the Director (Discipline) is of the opinion that member is guilty of any professional or other misconduct mentioned in the First Schedule; he shall place the matter before the Board of Discipline.

PART I - Professional misconduct in relation to Chartered Accountants in practice

A Chartered Accountant in practice is deemed to be guilty of professional misconduct if he:

Clause (1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.



The above clause is intended to safeguard the public against unqualified accountant practicing under the cover of qualified accountants. It ensures that the work of the accountant will be carried out by a Chartered Accountant who may be his partner, or his employee and would work under his control and supervision.

Clause (2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Explanation - In this item, “partner” includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part.

It is in order for a member to share his fees or profits with another member of the Institute and/or a firm of Chartered Accountants. A practicing Member of the Institute can share fees or profits arising out of his professional business with such members of other professional bodies or with

22.18 Advanced Auditing and Professional Ethics

such other persons having such qualifications as may be prescribed from time to time by the Council.

The Council has prescribed [**Regulation 53A(1)** of the Chartered Accountants Regulations, 1988] the professional bodies, which are as under:-

- (a) The Institute of Company Secretaries of India established under the Company Secretaries Act, 1980.
- (b) The Institute of Cost & Works Accountants of India established under the Cost & Works Accountants Act, 1959.
- (c) Bar Council of India established under the Advocates Act, 1961.
- (d) The Indian Institute of Architects established under the Architects Act, 1972.
- (e) The Institute of Actuaries of India established under the Actuaries Act, 2006.

Further, the Council has also prescribed [Regulation 53A(3) of the Chartered Accountants Regulations, 1988] the persons qualified in India, which are as under:

- (i) Company Secretary within the meaning of the Company Secretaries Act, 1980;
- (ii) Cost Accountant within the meaning of the Cost and Works Accountants Act, 1959;
- (iii) Actuary within the meaning of the Actuaries Act, 2006;
- (iv) Bachelor in Engineering from a University established by law or an Institution recognised by law;
- (v) Bachelor in Technology from a University established by law or an institution recognised by law;
- (vi) Bachelor in Architecture from a University established by law or an institution recognised by law;
- (vii) Bachelor in Law from a University established by law or an institution recognised by law;
- (viii) Master in Business Administration from Universities established by law or technical institutions recognised by All India Council for Technical Education.

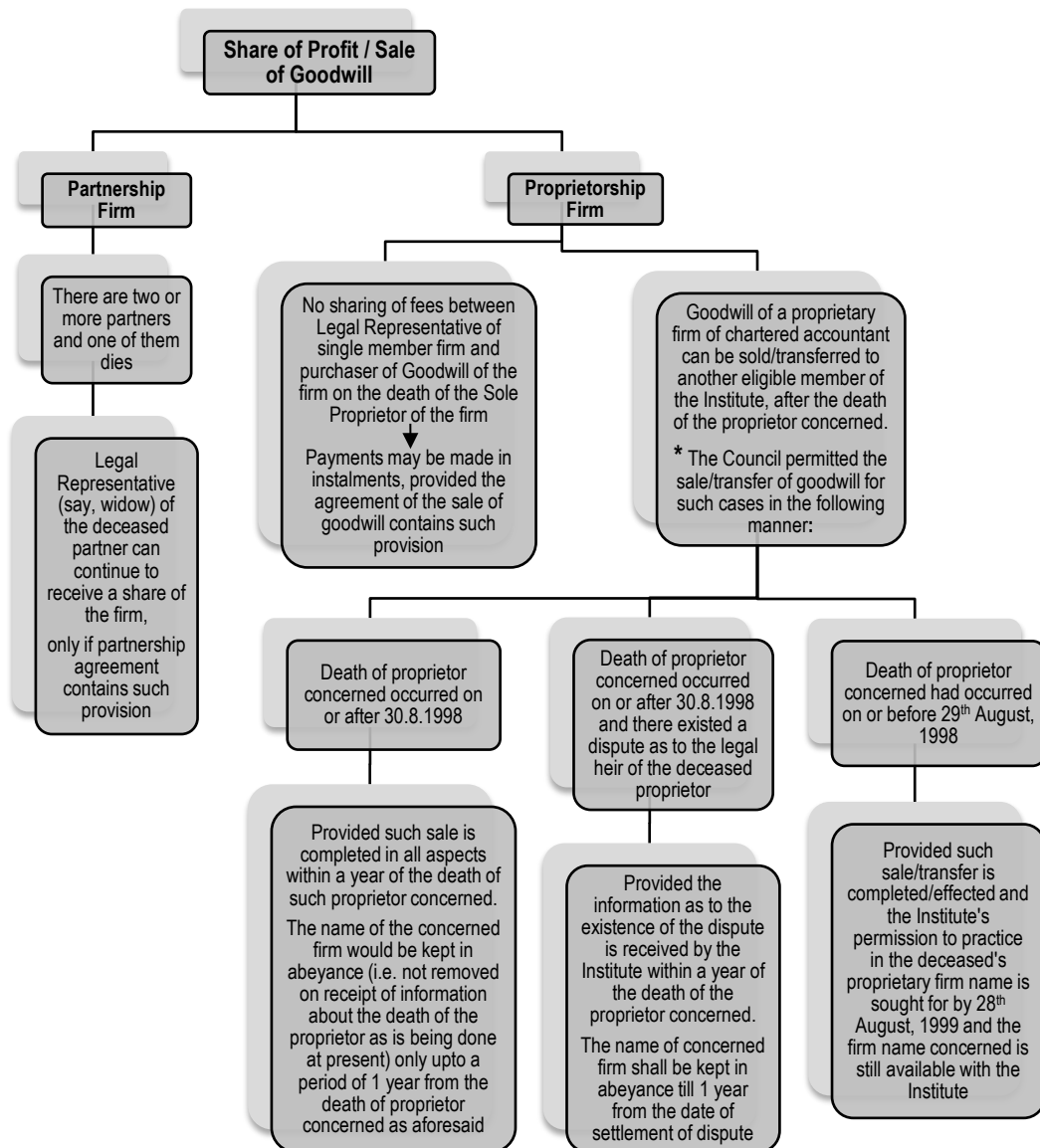
The Institute came across certain Circulars/Orders issued by the Registrars of various State Co-operative Societies wherein it has been mentioned that certain amount of audit fee is payable to the concerned State Government and the auditor has to deposit a percentage of his audit fee in the state Treasury by a prescribed challan within a prescribed time of the receipt of Audit fee. The Council considered the issue and while noting that the Government is asking auditors to deposit such percentage of their audit fee for recovering the administrative and other expenses incurred in the process, the Council decided that as such there is no bar in the Code of Ethics to accept such assignment wherein a percentage of professional fee is deducted by the Government to meet the administrative and other expenditure.

Considering the case where a Chartered Accountant gave 50% of the audit fees received by him to the complainant, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years, it was held by the Council that in substance the Chartered Accountant had shared his profits and, therefore, was guilty of

professional misconduct under the clause. It is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

(D. S. Sadri vs B.M. Pithewala - 14th & 17th September, 1974)

Treatment of Goodwill –



* In case of a partnership firm when all the partners die at the same time, the above Council decision would also be applicable.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 4(b), 10(c), 29(c), 30(a), 32(a) of the Practice Manual.]

Clause (3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

Provided that nothing herein contained shall be construed as prohibiting a member 'from entering into profit sharing or other similar arrangements, including receiving any share commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this part.

Just as a member cannot share his fees with a non-member, he is also not permitted to receive and share the fees of others except for sharing with Member of such professional body or other person having such qualification as may be prescribed (Regulation 53A of the Chartered Accountants Regulations, 1988) by the Council for the purpose of Clause (2), (3) and (5) of Part I of First Schedule. Such a restriction is necessary so that a Chartered Accountant who is often required to engage or to recommend for engagement by his clients, the services of the members of other professions, cannot share the fees received by other persons who are otherwise not permitted by the Council in terms of provision of this clause.

Clause (4) enters into partnership, in or outside India, with any person other than Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

The Council has prescribed Regulation 53A(3) (as discussed under clause (2) of this part) and Regulation 53B of the Chartered Accountants Regulations, 1988 for the persons qualified and the professional bodies.

The Regulation 53B prescribes the membership of following professional bodies for entering into partnership:

- (a) Company Secretary, member, The Institute of Company Secretaries of India, established under the Company Secretaries Act, 1980;
- (b) Cost Accountant, member, The Institute of Cost and Works Accountants of India established under the Cost and Works Accountants Act, 1959;
- (c) Advocate, member, Bar Council of India established under the Advocates Act, 1961;
- (d) Engineer, member, The Institution of Engineers, or Engineering from a University established by law or an institution recognized by law.
- (e) Architect, member, The Indian Institute of Architects established under the Architects Act, 1972;
- (f) Actuary, member, The Institute of Actuaries of India, established under the Actuaries Act, 2006.

Some of the decisions of the Council under this clause are given below:

Where a Chartered Accountant had engaged himself as a partner in two business firms and Managing Director in two Companies and was also holding Certificate of Practice without obtaining permission of the Institute. Held that he was guilty of professional misconduct *inter alia* under Clauses (4) and (11).

(Harish kumar in re:- Pages 286 of Vol. VIII (2) of Disciplinary cases – Council's decision dated 1st to 3rd August, 2001)

The Respondent was a Taxation Advisor of a group of Companies. During search and seizure under Section 132 of The Income Tax Act, 1961 of the group and also of the Chartered Accountant, the Complainant found that the Respondent was colluding with this group in evasion of tax. The Respondent had signed two sets of financial statements of the same auditee, for the same financial year. The two financial statements showed different figures of contract receipts, net profits and balance sheet. He was grossly negligent in the conduct of his professional duties. The Respondent admitted that he was managing partner/partner in two partnership firms where there were other partners who were not Chartered Accountants. Held, the respondent is guilty under Clause (4) of Part I of First Schedule and under Clauses (5), (6) & (7) of Part I of Second Schedule.

[Assistant Director of Income Tax (investment), Calicut v. P Subramanian. Council Decision of 281st Meeting held in October, (2008)].

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 1(d), 7(i) of the Practice Manual.]

Clause (5) Secures either through the services of a person who is not an employee of such Chartered Accountant or who is not his partner or by means which are not open to a Chartered Accountant, any professional business.

Provided that nothing herein contained shall be construed as prohibiting any agreement permitted in terms of item (2), (3) and (4) of this part.

“A man must stand erect, and not to be kept erect by others”, is a dictum by Marcus Aurelius which though applicable for a man in every walk of life is more so in the case of a professional life. He must seek work not through any agency, but by the respect, that he is able to command for his professional talent and skill and by the confidence he is able to inspire by his reputation. All forms of canvassing on that account are regarded unethical and are prohibited. The decision of the Council under this clause is given below:

A Chartered Accountant wrote various letters to officers of different Army Canteens giving details about him and his experience, his partner & office and the norms for charging audit fees. He was held guilty for violation of Clauses (5) & (6).

(Jethanand Sharda vs. Deepak Mehta – Council's decision dated 1st to 4th July, 1998 – Page 61 of Volume VIII(2) of Disciplinary Cases).

Clause (6) Solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Provided that nothing herein contained shall be construed as preventing or prohibiting -

- (i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or
- (ii) A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.

However, as per the guideline issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

It is an elaboration of the principle propounded in the preceding clause enjoining that for securing professional work the help of others should not be sought. This clause further enjoins on a member not to solicit professional work by means of advertisement, circular, personal communication or interview or by any other means. The members should not adopt any indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practiced so that members may maintain their independence of judgment and may be able to command the respect of their prospective clients.

In the early years of their professional career, members may find this restraint inconvenient and irksome. A question may arise in their minds as to how they would be able to find professional work if they are not permitted to advertise or solicit work.

A little reflection would show that professional work cannot be secured either by advertisement or by circulars or by solicitation. It can only be obtained by a member gradually building confidence in his ability and integrity. The service tendered by an accountant is of a personal and intimate nature and its value can be appraised only by personal contact and experience. A public advertisement is likely to lead to an impression that the professional person is over anxious to win confidence, which however will have the opposite effect. The satisfaction of clients would be the best advertisement, which would lead to other clients. Unabashed advertisement would affect the public esteem in which the profession is held and would act to the disadvantage of its members. An advertisement is not a key to success in the profession. It is the quality service, which attracts and retains the clients.

Consequent to amendment made by Chartered Accountant (Amendment) Act, 2006 in Clause (6) of Part I of the First Schedule, **Ban on Solicitation is relaxed** in the following situation of client or professional work:

- (i) If work or professional work occurs within the fraternity; or
- (ii) If professional work is secured from responding to tenders, or enquiries issued by various users of professional services or organization.

Some forms of soliciting work which the Council has prohibited are discussed below:

- (a) **Advertisement and note in the press** – Members should not advertise for soliciting work or advertise in a manner which could be interpreted as soliciting or offering to undertake professional work. They are also not permitted to use the less open method of circulating letters to a small field of possible clients. Personal canvassing or canvassing for clients of previous employer through the help of the employees are also not permitted. The **exceptions** to the above rule are:
- (i) A member may request another Chartered Accountant in practice for professional work.
 - (ii) a member may advertise changes in partnerships or dissolution of a firm, or of any change in address of practice and telephone numbers. Such announcements should be limited to a bare statement of facts and consideration given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.
 - (iii) a member is also permitted to issue a classified advertisement in the journal/newsletter of the Institute intended to give information for sharing professional work on assignment basis or for seeking partnership or salaried employment of an accountancy nature, provided it only contains the accountant's name, address or telephone number, fax number, e-mail address.
- (b) **Application for empanelment for allotment of audit and other professional work** – The Government departments, government companies/Corporations, courts, co-operative societies and banks and other similar institutions prepare panels of chartered accountants for allotment of audit and other professional work. Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the Chartered Accountant to make roving enquiries by applying to any such organization for having his name included in any such panel. It is permissible to quote fees on enquiries being received from such bodies, which maintain such panel.
- (c) **Publication of Name or Firm Name by Chartered Accountants in the Telephone or other Directories published by Telephone Authorities or Private Bodies** – The Council has held that it would not be proper for a chartered accountant to have entries made in a Telephone Directory either by making a special request or by means of an additional payment. The Council has also considered the question of permitting entries in respect of chartered accountants and their firms under specified groups in telephone/trade directories brought out by government and non-government agencies. It has decided to permit such entries subject to certain restrictions.
- (d) **Responding to Tenders, Advertisements and Circulars** – It is not prohibited to the members to respond to tenders and requests made by users of professional work.
- (e) **Publication of Books or Articles** – A member is not permitted to indicate in a book or an article, published by him, the association with any firm of Chartered Accountants.
- (f) **Issue of greeting cards or invitations** – The Council does not approve of the issue of greeting cards or personal invitations by members indicating their professional designation,

22.24 Advanced Auditing and Professional Ethics

status and qualification etc. However, the Council is of the view that the designation “Chartered Accountant” as well as the name of the firm may be used in greeting cards, invitations for marriages and religious ceremonies and any invitation for opening or inauguration of office of the members, change in office premises and change in telephone numbers, provided that such greeting cards or invitations etc. are sent only to clients, relatives and close friends of the members concerned.

- (g) **Soliciting professional work by making roving inquiries** – It is not permissible for a member to address letters or circulars to persons who are likely to require services of a Chartered Accountant since it would tantamount to advertisement.
- (h) **Seeking work from professional colleagues** – The issue of an advertisement or a circular by a Chartered Accountant, seeking work from professional colleagues on any basis whatsoever except as provided above would be in violation of this Clause.
- (i) **Scope of Representation which an auditor is entitled to make under Section 225(3) Companies Act, 1956 (now section 140(4)(iii) of the Companies Act, 2013)** – The right to make representation does not mean that an auditor has any prescriptive right or a lien to an audit. The wording of his representation should be such that apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may, in addition, indicate if he so chooses his willingness to continue as auditor if re appointed by the shareholders.
- (j) **Acceptance of original professional work by a member emanating from the client Introduced to him by another member** – The Council has decided that a member should not accept the original professional work emanating from a client introduced to him by another member. If any professional work of such client comes to him directly, it should be his duty to ask the client that he should come through the other member dealing generally with his original work.
- (k) **Giving public Interviews** – While giving any interview or otherwise furnishing details about themselves or their firms in public interviews or to the press or at any forum, the members should ensure that it should not result in publicity. Due care should be taken to ensure that such interviews or details about the members or their firms are not given in a manner highlighting their professional attainments.
- (k) **Members and/or firms who publish advertisements under Box numbers** – Members/Firms are prohibited from inserting advertisements for soliciting clients or professional work under box numbers in the newspapers. This practice is in violation of this clause.
- (m) **Website** –

The Council at its 212th meeting held in January, 2001 approved the detailed guidelines for posting the particulars on Website by Chartered Accountant(s) in practice and firm(s) of Chartered Accountants in practice. Subsequently, the Council at its 235th meeting held in July, 2003 amended sub-para (8) & (20) of the said

guidelines. Thereafter, the Council at its 242nd meeting held in April, 2004 and its 345th Meeting held in August, 2015 again revised the said guidelines. The amended guidelines issued by the Council are as under:*

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

** The Council at its 345th Meeting amended the para 6(ix) of the Guidelines*

(iv) *Nature of services rendered (to be displayable only on specific “pull” request)*

(v) **Partners**

Partners Name	Year of Qualification	Other Qualification(s)	Tel Off. – Direct Res. Mobile E-mail address	Area of Experience (to be displayable only on Specific “pull” request)

(vi) **Details of Employees –**

Professional	Others	Name	Designation	Area of Experience (to be displayable only on Specific “pull” request)

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

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

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

Note*: *Disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that “This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/area where such regulator has jurisdiction] vide [Rule/ Directive etc. under which the disclosure is required by the Regulator].*

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

(8) *Display of Passport size photograph is permitted.*

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

* The amendment shown in bold was made pursuant to the decision taken by the Council at its 345th Meeting held on 14th -16th August, 2015

- (10) The bulletin boards can be provided.*
- (11) The chat rooms can be provided which permit chatting amongst members of the ICAI and between Firms and its clients. The confidentiality protocol would have to be observed.*
- (12) The members/firms can provide on line advice to their clients who specifically request for the advice whether free of charge or on payment.*
- (13) The listing on suitable search engine should be permitted. However, the field of search should be restricted only to the field of "Chartered Accountants" or "CA" or "Indian CA", "Indian CPA", "Indian Chartered Accountant" or any permutation or combination related thereto. The Websites would be subjected to the guidelines contained herein and normally would not be vetted by the Institute of Chartered Accountants of India (ICAI). ICAI at its sole discretion may vet any of the Websites created by its members or individual Chartered Accountant or firms of Chartered Accountants and would have powers to direct deletion of certain portions and/or issue specific directions. In addition, necessary action can be taken in accordance with the Chartered Accountants Act, 1949 and the Regulations framed thereunder, in case there is any violation of the above guidelines.*
- (14) The details in the Website should be so designed that it does not amount to soliciting client or professional work. In case any content or technical feature of Website is against the professional Code of Conduct and Ethics as well as the restrictions contained in the schedules to the Chartered Accountants Act, 1949 or against the guidelines or directions issued by ICAI from time to time, appropriate action will be initiated by the ICAI in terms of its disciplinary mechanism either suo-motto or on complaint as provided under the Chartered Accountants Act, 1949.*
- (15) The Website should ensure adequate secrecy of the matters of the clients handled through Website,*
- (16) A number of Chartered Accountants Societies or other bodies are creating databases of Chartered Accountants or Chartered Accountants' Firms and are offering listing to Chartered Accountants. Such listing would be permitted with or without payment. In case a Chartered Accountant or Chartered Accountants' Firm is a member of a professional body or association or Chamber of Commerce and they offer listing to the members or firm, the same would be permitted.*
- (17) The Institute of Chartered Accountants of India will regularly inform the aforesaid guidelines to the members and the Chartered Accountants' Firms to ensure the strict compliance of the guidelines. The guidelines may be revised from time to time.*
- (18) No Advertisement in the nature of banner or any other nature will be permitted on the Website.*

- (19) *The Website should be befitting the profession of Chartered Accountants and should not contain any information or material which is unbecoming of a Chartered Accountant.*
- (20) *The Website may provide a link to the Website of ICAI, its Regional Councils and Branches and also the Website of Govt./Govt. Departments/Regulatory authorities/other Professional Bodies, such as, American Institute of Certified Public Accountants (AICPA), the Institute of Chartered Accountants of England & Wales (ICAEW) and The Canadian Institute of Chartered Accountants (CICA).*
- (21) *The address of the Website can be different from the name of the firm. But it should not amount to soliciting clients or professional work or advertisement of professional attainments or services. The Website address should be as near as possible to the individual name/trade name, firm name of the Chartered Accountant in practice or firm of Chartered Accountants in practice. The Ethical Standards Board (ESB) of ICAI will decide in case there is any difficulty.*
- (22) *The Website should mention the date upto which it is updated and the information should not be at material variance from the information as per the ICAI's records.*

The website address of the member be obtained on annual basis in the annual form required to be filed by the member while paying fee and the same be taken as entry on record & the website address of the member be provided to members as part of the membership record. If the member chose not to give his website address, it did not prevent the Institute to take suitable action against him in case his noncompliance with the guidelines.

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

Some of the decisions of the Council/High Courts on this clause are given below:

Solicitation – Where a chartered accountant firm issued a letter of authority in favour of two other chartered accountants to accept and carry out audits of Co-operative Societies on its behalf and they (the two chartered accountants) issued circulars of which the firm was not aware - Held, that the firm was not guilty of professional misconduct. [V.B. Kirtane (1958)] But the person, in whose favour the letter of authority was given in the above case, was held guilty. [MR Walke (1958)]

A chartered accountant sent a printed circular to a person unknown to him offering his services in profit planning and profit improvement programmes. The circular conveyed the idea that it was meant for strangers only. Held, the chartered accountant was guilty of professional misconduct under the clause as he used the circulars to solicit clients and professional work. [*B.S.N. Bhushan (1965)*]

A chartered accountant wrote several letters to Assistant Registrars/ Registrars of Co-operative Societies, Government of West Bengal requesting for allotment of audit work and to enroll his name on panel of auditors. Held he was guilty of professional misconduct under the clause. The activities of the chartered accountant went much beyond the instructions of the Council to the effect that roving enquiries should not be made with the Government Department for empanelling the name unless it had been ascertained in advance that specific panel was being maintained. It was also held that an auditor of co-operative societies under a license granted by co-operative department was not its employee and, therefore, he could not solicit work. [*Chief Auditor of Co-operative Societies, West Bengal vs. B.B. Mukherjee (1967)*]

A chartered accountant, inspite of the previous reprimand, sent letters to registrar Co-operative societies, Calcutta, stating that no allotment of audit was made to him and requested to take action immediately and oblige. Held he was guilty of professional misconduct under the clause. [*D.N. Das Gupta, Chief auditor of Co-operative Societies, West Bengal vs. B.B. Mukherjee (1969)*]

A Chartered Accountant approached the principal of a secondary school through a third person known to the principal for his appointment as auditor of that school. Further, the chartered accountant misrepresented to the previous Auditor that he had been offered appointment as auditor of the school and enquired whether he had any objection to his accepting the same though it was a fact that the appointment of chartered accountant was not made, the chartered accountant was guilty of professional misconduct under the clause. It was further held that writing letter by the Chartered Accountant to the previous auditor offering his services to audit the accounts of school was not wrong as it was an offer to professional colleague and not to a prospective client. [*M. L. Agarwal (1973)*]

A member was found guilty of professional misconduct under Clauses (6) and (7) Part I of the First Schedule for having issued circular letter regarding change of address of his firm to persons who were not in professional relationship with him and for having written to the shareholders thanking them for appointing him as auditor. He was reprimanded by the Council under Section 21(4), on an appeal made by the Council having regard to the ethical requirement about publicity by the members of the Institute as laid down in the "Code of Conduct". [*K.K. Mehta vs. M..K. Kaul (1975)*]

An advertisement was published in a newspaper containing the member's photograph wherein he was congratulated on the occasion of the opening ceremony of his office. He was found guilty by the Council and later, by High Court of violating the Clause (soliciting work by advertisement). The following observations of the High Court may be relevant.

- (a) The advertisement which had been put in by the member is a noticeable one and the profession of Chartered Accountancy should maintain high standards of integrity, professional ethics and efficiency.

22.30 Advanced Auditing and Professional Ethics

- (b) If soliciting of work is allowed the independence and forthrightness of a Chartered Accountant in the discharge of duties cannot be maintained and therefore some discipline must be maintained by the profession. *[G.P. Agrawal (1982)]*

A member who got an advertisement published in a newspaper offering his "services in matters of Accounts, Income Tax, Labour laws, Law matters and Management Services was found guilty in terms of this clause as also under Clause (7). *[Anil K. Garg (1987)]*

A member had an advertisement published in a newspaper regarding inauguration of his professional office. It was held that having regard to:

- (i) the nature of the advertisement
- (ii) the function organised on that occasion
- (iii) the persons invited
- (iv) the medium used
- (v) the names of various concerns which had conveyed their good wishes
- (vi) the advertisement having been released by the Respondent himself and he had solicited professional work by advertisement, he was found guilty in terms of this clause. *[Shashindra S. Ostwal (1988)]*

A member wrote a letter to a Company in standard format highlighting his expertise in sales tax matters and had requested for a draft of ₹ 200/- if his knowledge of the Sales tax matters has been found worthwhile. The member was found guilty in terms of this Clause. *[K.A. Gupta (1989)]*

Where a Chartered Accountant had visited personally the clients for securing the appointment as auditors of the Institutions. Held that he was guilty under Clause (6) of Part I of First Schedule. *[J.S. Bhati Vs. M.L Aggarwal. (1991)]*

Where a Chartered Accountant had addressed an undated but signed letter to-a Bank requesting for empanelment of his firm as auditor along with the particulars of his firm showing the past experience and other details of the firm; and a Member of Parliament had also sent a letter to the Bank recommending the name of the said Chartered Accountant's firm for immediate empanelling for Internal Audit/Inspection Audit/Management Audit, Expenditure Audit. Held that the member was guilty under Clause (6) of Part I of the First Schedule. *[Naresh C. Aggarwal (1992)]*

Where a Chartered Accountant had sent a letter on the letterhead of his firm to a non-member introducing himself as a chartered accountant giving details of services rendered by him and the schedule of his fees for rendering various kinds of services. Held that he was guilty under the clause. *[Vijay Kumar Goel (1994)]*

Where a Chartered Accountant had written a letter to a Co-operative Society wherein he had mentioned that he had been authorised by the Registrar of Societies to conduct the statutory audit of the Societies and requested it to contact him. Held that it tantamount to solicitation of the audit and he had violated the provisions of the clause. *[M. V. Lonkar (1996)]*

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 1(a), 3(c), 8, 9(ii), 10(d), 13(a), 18(a), 20(c), 20(d), 24(c), 24(d), 25(a), 27(b), 29(d), 32(b), 34 of the Practice Manual.]

Clause (7) Advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

This clause prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

It is improper for a Chartered Accountant to state on his professional documents that he is an Income-tax Consultant or a Cost Consultant or a Management Consultant.

The date of setting up the practice by a member or the date of establishment of the firm on the letterheads and other professional documents, etc. should not be mentioned. However in the Website, the year of establishment can be given on the specific "pull" request.

A member must not use the designation such as 'Member of Parliament', Municipal Councilor or any other functionary in addition to that of Chartered Accountant.

Members of the Institute in practice who are otherwise eligible may practice as advocates subject to the permission of the Bar Council but in such case, they should not use designation 'chartered accountant in respect of the matters involving the practice as an advocate. In respect of other matters they should use the designation 'chartered accountant' but they should not use the designation 'chartered accountant' and 'advocate' simultaneously.

It is not proper for Chartered Accountant to use the designation "Chartered Accountant" except on professional documents, visiting cards, letterheads or sign boards and under the circumstances clarified under para (f) of Clause (6).

The name, description and address of member (or firm) may appear in any directory or list of members of a particular body in which the names are listed alphabetically. For a specialised directory or a publication such as a "Who's Who" (including those compiled on purely local basis), a member should use his discretion in supplying information, bearing in mind the nature and purpose of the publications. In addition to his name, description and address and those of his firm, a member may give where appropriate, directorship held and reasonable personal details and may state his outside interests. He should not, however, give the names of any of his clients or details of the service offered by his firm.

22.32 Advanced Auditing and Professional Ethics

Publication of Name or Firm Name by Chartered Accountants in the Telephone or other Directories published by Telephone Authorities or Private Bodies. Detailed directions of the Council in this regard are published under Clause (6).

There should be no objection to the publication of photographs and brief particulars of members in magazines provided no payment is made for such publication and there is no advertisement of professional attainments.

Further via a clarification on whether the Chartered Accountants in practice can print their photograph on their visiting cards, the Ethical Standard Board (ESB) of the Institute has opined that mostly the business class prints the photograph on their visiting cards for promoting their business and soliciting clients. As such, it is not permissible for the chartered accountants in practice to print their photograph on their visiting cards.

However, a member in practice is allowed to print Quick Response Code (QR Code) on the visiting Card, provided that the Code does not contain information that is not otherwise permissible to be printed on a visiting Card.

A special exemption has been made as regards publication of the name and address of a member or that of his firm, with the description Chartered Accountant(s), in an advertisement appearing in the press in the following circumstances, provided that the advertisement is not displayed more prominently than is usual for such advertisements or the member or that of his firm with the designation Chartered Accountant(s) appears in type not bolder than the substance of the advertisement.

- (a) Advertisements for recruiting staff in the members' own office.
- (b) Advertisements inserted on behalf of clients requiring staff or wishing to acquire or dispose of business or property.
- (c) Advertisement for the sale of a business or property by a member acting in a professional capacity as trustee, liquidator or receiver.

When advertising for staff, it is desirable that members should avoid the expression such as "a well-known firm", since this would be form of advertisement. Similar considerations apply to advertisements for articled clerks. The advertisements should not contain any promotional element nor should there be any suggestion that the services offered by the Chartered Accountant or his firm are superior to those offered by other accountants.

Notice in the press relating to the success in an examination of an individual candidate, should not contain any element of undesirable publicity either in relation to the articled/audit clerk or an employee or the member or the firm with whom he has served.

It is usual for local papers to publish details of the examination success of local candidates. Some biographical information is often included. The rule aforementioned is not intended to discourage the printing of news of local interest but is intended to indicate the need for restraint. The candidate's name and address, school and local background, examinations passed with details of any prize or place gained, the name of the principal, firm and town in which the principal practices may be published.

The reports and certificates issued by a Chartered Accountant brings him to the notice of the public in a greater or lesser degree. It is therefore incumbent upon him to ensure that the extent and manner of publications of certificates are limited to what is necessary to enable the report or certificate to serve its proper purpose.

Member may appear on television and films and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialized knowledge directly relevant to the subject matter of the programme may also be given but no reference should be made, in the case of practicing member to the name and address or services of his firm. What he may say or write must not be promotional of his or his firm but must be an objective professional view of the topic under consideration.

Publicity is permitted for appointments to positions of local or national importance or for the views of members on matters of similar importance. Mention of the membership of the Institute is desirable in such cases. What should be aimed at is to achieve suitable publicity for the Institute and its member generally. Members giving talks or lectures or attending a conference may describe themselves as Chartered Accountants only when they are acting in their capacity as Chartered Accountant. Here again reference to the professional firm of the member should not be given.

A professional accountant in public practice holding training courses, seminars etc. for his staff may also invite the staff of other professional accountants and clients to attend the same. However, undue prominence should not be given to the name of the profession accountant in any booklet or document issued in connection therewith.

Members writing articles or letters to the press on subjects connected with the profession may give their names and use the description Chartered Accountants.

Council Guidelines for Advertisement for the Members in Practice

(Issued Pursuant to Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949)

The Members may advertise through a write up setting out their particulars or of their firms and services provided by them subject to the following Guidelines and must be presented in such a manner as to maintain the profession's good reputation, dignity and its ability to serve the public interest.

The Member(s)/Firm(s) should ensure that the contents of the Write up are true to the best of their knowledge and belief and are in conformity with these Guidelines and be aware that the Institute of Chartered Accountants of India does not own any responsibility whatsoever for such contents or claims by the Writer Member(s)/ Firm(s).

With regard to the size of signboard for his office that member can put up, it is matter in which the members should exercise their own discretion and good taste. Use of glow signs or lights on large-sized boards as is used by traders or shop-keepers would not be proper. A member can have a name board at the place of his residence with the designation of a Chartered

22.34 Advanced Auditing and Professional Ethics

Accountant provided it is a name plate or name board of an individual member and not of the firm.

The Council has issued following Guidance Note for Members Holding Certificate of Practice on acceptance of directorships in companies.

The Council's attention has been drawn to the fact that more and more companies are appointing Chartered Accountants as directors on their Boards. The prospectus or public announcements issued by these companies often publish descriptions about the Chartered Accountant's expertise, specialization and knowledge in any particular field or add appellation or adjectives to their names. Attention of the members in this context is invited to the provisions of Clauses (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act.

In order that the inclusion of the name of a member of the Institute in the prospectus or public announcements or other public communications issued by the companies in which the member is a director does not contravene the above noted provisions, it is necessary that the members should take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the member. While it may be difficult to lay down a rigid rule in this respect, the members must use their good judgement, depending upon the facts and circumstances of each case to ensure that the above noted provisions are complied with both in letter and spirit.

It is advisable for a member that as soon as he is appointed as a director on the Board of a Company, he should specifically invite the attention of the management of the company to the aforesaid provisions and should request that before any such prospectus or public announcements or public communication mentioning the name of the member concerned, is issued, the material pertaining to the member concerned should, as far as practicable be got approved by him. The use of the expression 'Chartered Accountant' is permissible. However, the member must ensure that descriptions about his expertise, specialization and knowledge in any particular field of other appellation or adjectives are not published with his name. Particulars about directorships held by the member in other companies can, however, be given, but the name of the Firm of Chartered Accountants in which the member is a partner, should not be given.

The Council has issued the following guidelines for use of expressions such as 'Associates of 'Correspondents of... etc. on letter heads, visiting cards etc. of firms of Chartered Accountants:

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

For use of logos by Members on letter heads, visiting cards etc. the Council has decided that the logos unconnected with the first letter of the name of the firm or its partners or proprietors will not be permitted for use by members in practice / firms of chartered accountants on their letter heads, visiting cards etc. as the same amounts to advertisement or smacking of publicity. Accordingly, an announcement was published in October, 1995 issue of "The Chartered Accountant".

Subsequent to above, the Institute came across cases of registration of firm name in circumvention of the provisions contained in the Regulation 190 of the Chartered Accountants Regulations, 1988. The members/firms by themselves or through engineered name had been seeking to obtain firm name approval based on the name of the partner/s selected in the manner that logo of the firm would be identical to the firm name which would have not otherwise been permissible as firm name under Regulation 190. In order to ensure compliance with the Regulations, the Council at its meeting held in December, 1997, therefore, decided that the use of logo/monogram of any kind/form/style/design/colour, etc. whatsoever on any display material or media e.g. paper stationery, documents, visiting cards, magnetic devices, internet, sign board, by the members in practice and/or the firm of Chartered Accountants, be prohibited. Use/printing of member/firm name in any other manner tantamounting to logo/monogram was also prohibited.

An announcement was published in February, 1998 issue of the Journal at pages 54 & 55 informing that the use of logo/monogram as above was prohibited with immediate effect in the case of newly enrolled members in practice/new firms of Chartered Accountants. The members already in practice/existing firms of Chartered Accountants using logo/monogram were advised to take immediate steps for discontinuing use of the logo/monogram so as to stop using the logo/monogram in any case before 1st July, 1998. The Council at its meeting held in December 1999 has reiterated its decision to ban logo.

Some of the decisions of the Council/High Courts on this clause are given below:

Where a Chartered Accountant used the designation 'Incorporated Accountant London' and 'Registered Accountant', India, in the Balance Sheet and also failed to report to the shareholders in the prescribed form under the Banking Companies Act - Held the chartered accountant was guilty of the two charges. The word 'member' in Section 21 of the Act should be constructed as including a past member for the purpose of inquiry, as what was required membership at the time of the commission of the alleged misconduct. [*Mirza M. Hussain (1955)*]

A chartered accountant wrote several letters to Government Department, inter alia, pointing out seniority of his firm, sending his life sketch and stating that he had a glorious record of service to the country as well as to the organisation of accountancy profession with a view to get the audit work. These letters were clearly in the nature of advertising professional attainments. Held, he was guilty of professional misconduct under the clause. [*Sirdar P.S. Sodhbans (1969)*]

Where a Chartered Accountant had issued two insertions in a Journal published by a Chamber of Commerce expressing his willingness to offer the concession in respect of all services offered by him. Held that he was guilty under Clauses (6) & (7). [*N.O. Abraham Isaac Raj (1992)*]

22.36 Advanced Auditing and Professional Ethics

Where a Chartered Accountant had addressed a letter to the Managing Director of a company offering his services as a practicing chartered accountant and giving impression that the letter had been addressed to more than one organization for the above purpose, it was held that the member had contravened the provisions of Clauses (6) & (7). [*Yogash Gupta (1996)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 7(ii), 9(ii), 20(b), 21(a), 31(b), 34 of the Practice Manual.]

Clause (8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

It must be pointed out that professional courtesy alone is not the major reason for requiring a member to communicate with the existing accountant who is a member of the Institute or a certified auditor. The underlying objective is that the member may have an opportunity to know the reasons for the change in order to be able to safeguard his own interest the legitimate interest of the public and the independence of the existing accountant. It is not intended, in any way, to prevent or obstruct the change. When making the inquiry from the retiring auditor, the one proposed to be appointed or already appointed should primarily find out whether there are any professional or other reasons why he should not accept the appointment.

It is important to remember that every client has an inherent right to choose his accountant also that he may, subject to compliance, with the statutory requirements in the case of limited companies, make a change whenever he chooses, whether or not the reasons which had impelled him to do so are good and valid. The change normally occurs where there has been a change of venue of business and a local accountant is preferred or where the partner who has been dealing with the client's affairs retires or dies; or where temperaments clash or the client has some good reasons to feel dissatisfied. In such cases, the retiring auditor should always accept the situation with good grace.

The existence of a dispute as regards the fees not having been paid often may be the root cause of an auditor being changed, but this would not constitute valid professional reasons on account of which an audit should not be accepted by the member to whom it is offered. It is no doubt true that the incoming auditor should in appropriate circumstances use his influence in favour of his predecessor to have the disputes as regards the fees settled. Also a number of members would not accept appointment in such circumstances unless and until they are satisfied that the predecessor has been fairly treated, but there is no rule to that effect and the decision in this regard must rest with the good sense of the member himself.

The professional reasons for not accepting an audit could be:

- (i) Non-compliance of the provisions of Sections 224 and 225 of the Companies Act as mentioned in Clause (9) [now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013];
- (ii) Non-payment of undisputed audit fees by auditees other than in case of sick units for carrying out the statutory audit under the Companies Act or various other statutes; and
- (iii) Issuance of a qualified report.

In the first two cases, an auditor who accepts the audit would be guilty of professional misconduct. The Council has taken the view that the provision for audit fee made in accounts signed by both - the auditee and auditor shall be considered as 'undisputed' audit fees. In this connection, attention of members is invited to Council Guidelines No. 1-CA/(7)/02/2008 dated 08.08.08. In the said guidelines, Council has explained that the provision for audit fee in accounts signed by both the auditee and the auditor shall be considered as "undisputed" audit fee and "sick unit" shall mean where the net worth is negative.

In the last case, however, he may accept the audit if he is satisfied that the attitude of the retiring auditor was not proper and justified. If, on the other hand, he feels that the retiring auditor has qualified the report for good and valid reasons, it would be a healthy practice not to accept the audit. There is however no rule, written or unwritten, which would prevent an auditor from accepting the appointment offered to him in these circumstances. However, before accepting the appointment he should ascertain full facts of the case. For nothing will bring the profession to disrepute so much as the knowledge amongst the public that if an auditor is found to be "inconvenient" by the client, he could readily be replaced by another who would not displease the client and this point cannot be too over-emphasized.

What should be the correct procedure to adopt when a prospective client tells you that he wants to change his auditor and wants you to take up his work? There being two persons involved, the company and the old auditor, the former should be asked whether the retiring auditor has been informed of the intention to change. If the answer is in the affirmative, then a communication should be addressed to the retiring auditor. If, however, it is learned that the old auditor has not been informed, and the client is not willing to make the first move, it would be necessary to ask him the reason for the proposed change. If there is no valid reason for a change, it would be healthy practice not to accept the audit. If he decides to accept the audit he should address a communication to the retiring auditor.

As stated earlier the object of the incoming auditor, in communicating with the retiring auditor is to ascertain from him whether, there are any circumstances which warrants him not to accept the appointment. For example, whether the previous auditor has been changed on account of having qualified his report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. In all these cases it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit, and should he do so, he must also take into account the information while discharging his duties and responsibilities.

Sometimes, the retiring auditor fails without justifiable cause except a feeling of hurt because of the change, to respond to the communication of the incoming auditor. So that it may not create a deadlock, the auditor appointed can act, after waiting for a reasonable time for a reply.

The Council has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered

22.38 Advanced Auditing and Professional Ethics

Accountant who relies solely upon a letter posted “under certificate of posting” therefore does so at his own risk.

The view taken by the Council has been confirmed in a decision by the Rajasthan High Court in J.S. Bhati v.s. The Council of the Institute of Chartered Accountants of India and another. The following observations of the Court are relevant in this context:

“Mere obtaining a certificate of posting in my opinion does not fulfil the requirements of Clause (8) of Schedule I as the presumption under Section 114 of the Evidence Act that the letter in due course reached the addressee cannot replace that positive degree of proof of the delivery of the letter to the addressee which the letters of the law in that case required. The expression ‘in ‘ communication with’ when read in the light of the instructions contained in the booklet ‘Code of Conduct’ (now Code of Ethics) cannot be interpreted in any other manner but to mean that there should be positive evidence of the fact that the communication addressed to the outgoing auditor by the incoming auditor reached his hands. Certificate of posting of a letter cannot, in the circumstances, be taken as a positive proof of its delivery to the addressee”.

Members should therefore communicate with a retiring auditor in such a manner as to retain in their hands positive evidence of the delivery of the communication to the addressee. In the opinion of the Council, communication by a letter sent “Registered Acknowledgment due” or by hand against a written acknowledgment would in the normal course provide such evidence.

The Council is of the opinion that it would be a healthy practice if the practice of communication with the member who had done the work previously is followed in every case where a Chartered Accountant is required to give a certificate or in respect of a verification of the books of account for special purpose as well as in cases where he is appointed as a Liquidator, Trustee or Receiver and his predecessor was a Chartered Accountant.

As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to act jointly with the earlier auditor and to communicate with such earlier auditor.

It is desirable that a member, on receiving communication from the auditor who has been appointed in his place, should send a reply to him as soon as possible setting out in detail the reasons which according to him had given rise to the change and other attended circumstances but without disclosing any information as regards the affairs of the client which he is not competent to do.

The Council has also laid down the detailed guidelines on the subject as under:

- (1) The requirement for communicating with the previous auditor being a chartered accountant in practice would apply to all types of audit viz., statutory audit, tax audit, internal audit, concurrent audit or any other kind of audit.
- (2) Various doubts have been raised by the members about the terms “audit”, “previous auditor”, “Certificate” and “report”, normally while interpreting the aforesaid Clause (8). These terms need to be clarified.
- (3) As per para 2 of SA 200 on “Basic Principles Governing an Audit”, an “audit” is the independent examination of financial information of any entity, whether profit oriented or

not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

- (4) The term “previous auditor” means the immediately preceding auditor who held same or similar assignment comprising same/similar scope of work. The mandatory communication with the previous auditor being a Chartered Accountant is required even in a case where the previous auditor happens to be an auditor for a year other than the immediately preceding year.
- (5) As explained in para 2.2 of the Institute’s publication viz., ‘Guidance Note on Audit Report and Certificates for Special Purposes’, a “certificate” is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A “report”, on the other hand, a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor’s opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.
- (6) A communication is mandatorily required for all types of audit/report if the previous auditor is a chartered accountant. For certification, it would be healthy practice to communicate. In case of assignments done by other professionals not being chartered accountants, it would also be a healthy practice to communicate.
- (7) Although the mandatory requirement of communication with previous auditor being chartered accountant applies, in uniform manner, to audits of both government and non-government entities, yet in the case of audit of government is made well in time to enable the obligation must be complied with before accepting the audit. However, in case the time schedule given for the assignment is such that there is no time to wait for the reply from the outgoing auditor, the incoming auditor may give a conditional acceptance of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause. In his acceptance letter, he should make clear to the client that his acceptance of appointment is subject to professional objections, if any, from the previous auditors and that he will decide about his final acceptance after taking into account the information received from the previous auditor.

Some of the decisions of the Council/High Courts on this matter are briefly given in the following paragraphs:

A Chartered Accountant commenced the work of audit on the very day he sent letter to the ‘previous auditor - Held, he was guilty of professional misconduct under the clause. The appointment could be accepted only when the outgoing auditor does not respond within a reasonable time. [S.N. Johri vs. N.K. Jain (1973)]

22.40 Advanced Auditing and Professional Ethics

A Chartered Accountant sent a registered letter to the previous auditor after the commencement of the audit by him. Held he was guilty of professional misconduct under the clause. [*Radhey Shyam vs. K.S. Dubey (1974)*]

A chartered accountant had sent a communication to the previous auditor under certificate of posting without obtaining any acknowledgment thereof. The Council held the member guilty in terms of this Clause. On an appeal made by the member, the High Court observed that the expression “in communication with” when read in the light of the instructions contained in the booklet “Code of Conduct” could not be interpreted in any other manner but to mean that there should be positive evidence of the fact that the communication addressed to the outgoing auditor had reached his hands. Certificate of Posting of a letter could not in the circumstances be taken as positive evidence of its delivery to the addressee. [*M.L. Agarwal vs. J.S. Bhati (1975)*]

The provision of Clause (8) requiring a communication with the previous auditor is absolute and applicable even in respect of an appointment by the Government agencies and even in case where the member is aware that the previous auditor had been made aware of the appointment. [*Rajeev Kumar vs. R.K. Agrawal (1988)*]

The requirements of Clause (8) of Part I of the First Schedule can be considered to have been complied with only:

- (i) if there is evidence that a communication to the previous auditor had been by R.P.A.D.
- (ii) if there was positive evidence about delivery of the communication to the previous auditor.

In the absence of both, the member should be found to have contravened this Clause. [*R.M. Singhai vs. R.V. Agarwal (1988)*]

Where a Chartered Accountant had conducted tax audit of a firm without first communicating in writing with the Complainant, who was the previous tax auditor of the said firm. Held that he was guilty under the clause. [*V.A. Parikh vs. R.I. Galledar (1991)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 12(a), 13(b), 16(c), 26 of the Practice Manual.]

Clause (9) Accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956, in respect of such appointment have been duly complied with (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013).

The Companies Act, 2013 provides for the requirements which an auditor appointed in respect of a company should satisfy himself about, before he accepts the appointment. The relevant provisions are contained in Sections 139, 140, 141 and 142 of the said Act. Section 139 contains several provisions in the matter of appointment of auditors in different circumstances and situations; and Section 140 lays down the procedure which must be followed when a company desires to change its auditors, or when an auditor resigns from the company; whereas Section 141 provides the eligibility, qualifications and disqualifications of auditors; and Section 142 contains the provisions related to the remuneration of the auditor. In order that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory on the incoming auditor to ascertain from

the company that the appropriate procedure in the matter of appointment has been faithfully followed.

The following guidelines have been issued by the Council for this purpose:

- (1) The steps to be taken by an auditor of a company who is appointed in the following circumstances are indicated below:
 - (i) When the auditor appointed is the first auditor of the company.
 - (ii) When the auditor is appointed in place of an existing auditor who has resigned or has been removed or has ceased to hold office for any other reason.
 - (iii) When the auditor or auditors appointed by the company were holding this office jointly with others and one or more of such joint auditors are not reappointed.
 - (iv) When one or more of the auditors appointed by the company was/were not holding this office earlier.
- (2) Under Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, the incoming auditor has to ascertain whether the company has complied with the provisions of the above sections. The word “ascertain” means “to find out for certain”. This would mean that the incoming auditor should find out for certain as to whether the company has complied with the provisions of Sections 224, 224A and 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013). In this respect, it would not be sufficient for the incoming auditor to accept a certificate from the management of the company that the provisions of the above sections have been complied with. It is necessary for the incoming auditor to verify the relevant records of the company and ascertain as to whether the company has, in fact, complied with the provisions of the above Sections. If the company is not willing to allow the incoming auditor to verify the relevant records in order to enable him to ascertain as to whether the provisions of the above sections have been complied with, the incoming auditor should not accept the audit assignment.
- (3) (A) As regards the mode of sending the notice of the resolution to the members of the company as provided in Sections 224 and 225 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), it should be noted that there is no provision that the notice should necessarily be sent by registered post. The notice can be sent by the company in accordance with the provisions contained in Section 53 (now Section 20 of the Companies Act, 2013).

For the purpose of better understanding to the students, the relevant provisions of Section 20 of the Companies Act, 2013 are briefly summarised hereunder:

- (i) A document may be served on a company or an officer thereof sending it through registered post; or speed post; or courier service; or by leaving it at its registered office; or by means of electronic transmission.
- (ii) If the member or the person concerned has given specific direction to the Company that the notice should be sent to him through a particular mode, and has deposited with the Company the sum sufficient to defray the expenses for

22.42 Advanced Auditing and Professional Ethics

this purpose, the notice should be sent in such specified manner.

- (iii) For above purposes, the courier means a document sent through a courier which provides proof of delivery.
- (B) If it is not practicable to send the notice of the resolution to the members by post, such notice can be given either by advertisement in a newspaper having an appropriate circulation or in any other mode allowed by the Articles of Association of the Company.
- (C) In order to ascertain whether notice of the resolution has been sent to the members, the incoming auditor should ascertain whether there is sufficient evidence with the Company to indicate that the notice has been sent by any of the modes stated in (A) or (B) above. The despatch register, postage register, postal certificate (if notice is sent under postal certificate) or such other satisfactory evidence available with the company should be verified.
- (D) As regards the mode of sending the notice of the resolution to the retiring auditor as provided in Sections 224 and 225 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), attention is invited to the Department of Company Affairs circular dated 17.10.1981 issued to all Chambers of Commerce, which is reproduced below.
- “I am directed to say that it has been reported by the Institute of Chartered Accountant of India that difficulties are being experienced by retiring Auditors in the operation of the provisions of Section 225 of the Companies Act, 1956 whenever any appointment of a new auditor takes place. Such difficulties arise because of the fact that the copy of the special notice required to be served under Section 225(2) of the Act on the retiring auditors are not effectively served and proof of such service is not available. To obviate such difficulties, therefore, it is advisable than the copy of the special notice under Section 225(2) of the Act should be sent to the retiring auditors by Registered Post with A/D.”
- (E) Accordingly, it is necessary for the incoming auditor to satisfy himself that the notice provided for in Sections 224 & 225 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013) has been effectively served on the outgoing auditor (e.g. by seeing that the notice has been duly served through hand delivery or by Regd. Post A.D.). Production of a certificate of posting by the company would not be adequate for the purpose of the incoming auditor satisfying himself about compliance with Sections 224/225. Acknowledgement received from the outgoing auditor would be one of the forms in which satisfaction can be obtained.
- (4) A copy of the relevant minutes of the general meeting where the above resolution is passed duly verified by the Chairman of the meeting should also be obtained by the incoming auditor for his records.
- (5) If any annual general meeting is adjourned without appointing an auditor, no special notice for removal or replacement of the retiring auditor received after the adjournment can be

taken note of and acted upon by the company, since in terms of Section 190(1) of the Companies Act, 1956 (now Section 115 of the Companies Act, 2013), special notice should be given to the company at least fourteen clear days before the meeting in which the subject matter of the notice is to be considered. The meeting contemplated in Section 190(1) undoubtedly is the original meeting.

- (6) If the incoming auditor is satisfied that the company has complied with the provisions of Sections 224, 224A and 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), he should first communicate with the outgoing auditor in writing as provided in Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 before accepting the audit assignment.

In order to examine various ethical issues and safeguard the independence of the Auditors, the Council has set up Ethical Standards Board. This Committee examines various issues concerning professional ethics governing the members of the Institute which are either raised by the members or are taken up based on their importance. The recommendations of the Committee are forwarded to the Council for its consideration. This Committee is also charged with the responsibility of looking into the cases of removal and resignation of auditors and making an appropriate report to the Council. The following guidelines have been issued for this Committee for looking into the cases of Removal of Auditors:

- (A) Where an auditor resigns his appointment as an auditor of a Company or does not offer himself for reappointment as auditor of such company, he shall send a communication, in writing, to the Board of Directors of the Company giving reasons therefore if he considers that there are professional reasons. Therefore, if he considers that there are professional reasons connected with his resignation or not offering him for reappointment which, in his opinion should be brought to the notice of the Board, and shall send a copy of such communication to the Institute. It shall be obligatory on the incoming auditor, before accepting appointment, to obtain a 'copy of such communication, from the Board and consider the same before accepting the appointment.
- (B) Where an auditor, though willing for reappointment has not been reappointed, he shall file with the Institute a copy of the statement which he may have sent to the management of the company for circulation among the shareholders. It shall be obligatory on the incoming auditor before accepting the appointment, to obtain a copy of such a communication from the company and consider it, before accepting the appointment.
- (C) The Committee, on a review of the communications referred to in above paras may call for such further information as it may require from the incoming auditor, the outgoing auditor and the company and make a report to the Council in cases where it considers necessary.
- (D) The above procedure is also followed in the case of removal of auditors by the government and other statutory authorities.

[Students may note that, with the introduction of Companies Act, 2013, Clause 9 of Part I of the First Schedule to the Chartered Accountants Act, 1949 also needs to be

modified in view of the new Companies Act, 2013. Till the time the Chartered Accountants Act, 1949 along with the “Code of Ethics” gets amended in accordance with Companies Act, 2013, students may study and use section 139, 140 and 142 read with section 141 of the Companies Act, 2013 while applying the above clause.

Further, students may refer Chapter 6 of the Study Material for detailed knowledge on the abovementioned sections.]

CASE STUDY 1

CA Raja was appointed as the Auditor of Castle Ltd. for the year 2015-16. Since he declined to accept the appointment, the Board of Directors appointed CA Rani as the auditor in the place of CA Raja, which was also accepted by CA Rani.

Board can appoint the auditor in the case of casual vacancy under section 139(8) of the Companies Act, 2013. The non-acceptance of appointment by CA. Raja does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant is deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been fully complied with.

Hence, CA. Rani is guilty of professional misconduct since she accepted the appointment without verification of statutory requirements.

CASE STUDY 2

Mrs. X is a Director of ABC Pvt. Ltd. During the year 2015-16, the company appointed CA Mr. Y, Mrs. X's spouse, as its statutory auditor. Mr. Y used to deliver audit report without any comments or disclosures, thereupon.

As per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel. The definition of ‘Relative’ includes husband and wife.

Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

In this case Mrs. X is a Director of ABC Pvt. Ltd. and the company has appointed Mr. Y, Chartered Accountant, Mrs. X's spouse, as its statutory auditor. Mr. Y should not accept the appointment as statutory auditor of the company, where his wife Mrs. X is a director. This is contravention of section 141 of the Companies Act, 2013.

Therefore, Mr. Y is liable for misconduct under the said clause since he accepted the appointment without first verifying the compliance of statutory requirements.

Some decisions of the Council/High Courts on this subject are given below:

Failure to communicate with the previous auditor-

Where a chartered accountant failed to communicate in writing with the previous auditor of his appointment as auditor of a co-operative bank and such omission was not intentional. Held that the breach was only technical and that it was open to the High Court to award a lesser punishment than removal of a member. [*S.V. Kharwandikar vs. O.K. Borkar (1952)*]

Where a chartered accountant applied in response to an advertisement in a newspaper for appointment as auditor and was appointed by the Directors and failed to communicate with the previous auditor and ascertain from the company whether the requirements of the Companies Act as regards the appointment of the auditors were duly complied with. Held the respondent was guilty on both the counts under Clauses (8) and (9). [*B.N. Mohan vs. K.C.J. Satyawadi (1955)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 15(a), 24(a), 26, 30(d) of the Practice Manual.]

Clause (10) Charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

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

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

The Council of the Institute has however framed Regulation 192 which exempts members from the operation of this clause in certain professional services. The said Regulation 192 is reproduced -

192. Restriction on fees - No Chartered Accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings or results of such work, provided that:

- (a) "In the case of a receiver or a liquidator, the fees may be based on a percentage of the realization or disbursement of the assets;
- (b) In the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits;
- (c) In the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of property valued;
- (d) in the case of certain management consultancy services as may be decided by the resolution of the Council from time to time, the fees may be based on percentage basis which may be contingent upon the findings, or results of such work;**
- (e) in the case of certain fund raising services, the fees may be based on a percentage of the fund raised;**
- (f) in the case of debt recovery services, the fees may be based on a percentage of the debt recovered;**
- (g) in the case of services related to cost optimisation, the fees may be based on a percentage of the benefit derived; and**
- (h) any other service or audit as may be decided by the Council.**

CASE STUDY

CA Deepak, a Chartered Accountant prepared a project report for one of his clients to obtain bank finance (long-term) of ₹ 50 lakhs from a Commercial Bank. Consequent to the sanction of the loan by the bank CA Deepak raised a bill for his services @ 2% of the loan sanctioned.

Clause (10) of Part I to First Schedule to the Chartered Accountants Act prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him.

However, this restriction is not applicable where such payment is permitted by the Chartered Accountants Act, 1949. The Council of the Institute has framed regulation 192 which exempts certain professional services from the operation of Clause (10).

The services rendered by CA Deepak are not covered under the said exemption and hence CA Deepak is liable for professional misconduct.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 15(c) of the Practice Manual.]

Clause (11) Engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor.

This is a provision introduced to restrain a member in practice from engaging himself in any business or occupation other than that of chartered accountant except when permitted by the Council to be so engaged. The objective is to restrain members from carrying on any other business in conjunction with the profession of accountancy and combining such work with any business, which is not in keeping with the dignity of the profession. Another reason for the introduction of such prohibition is that a chartered accountant, if permitted to enter into all kinds of business, would be able to advertise for his other business and thereby secure an unfair advantage in his professional practice.

The Council, on a very careful consideration of the matter, has formulated Regulation, 190A and 191 which are reproduced below, specifying the activities with which a member in practice can associate himself with or without the permission of the Council.

190A. Chartered Accountant in practice not to engage in any other business or occupation.

“A chartered accountant in practice not to engage in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council”.

191. Part-time employment a Chartered Accountant in practice may accept.

“Notwithstanding anything contained in Regulation 190A but subject to the control of the Council, a chartered accountant in practice may act as a liquidator, trustee, executor, administrator, arbitrator, receiver, adviser or representative for costing, financial or taxation matter, or may take up an appointment that may be made by the Central Government or a State Government or a court of law or any other legal authority or may act as a Secretary in his professional capacity, provided his employment is not on a salary-cum-full-time basis”.

Appendix 9 C.A. Regulations, 1988

The General and specific Resolutions passed by the Council under the power vested in it under Regulation 190A as included in Appendix 9 of C.A. Regulations, 1988 are also reproduced below for information.

General Resolution

Permission granted generally - Members of the Institute in practice be generally permitted to engage in the following categories of occupations, for which no specific permission from the Council would be necessary in individual cases:

- (1) Employment under Chartered Accountants in practice or firms of such chartered accountants.
- (2) Private tutorship.
- (3) Authorship of books and articles.

22.48 Advanced Auditing and Professional Ethics

- (4) Holding of Life Insurance Agency License for the limited purpose of getting renewal commission.
- (5) Attending classes and appearing for any examination.
- (6) Holding of public elective offices such as M.P., M.L.A. and M.L.C.
- (7) Honorary office leadership of charitable-educational or other non-commercial organisations.
- (8) Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.
- (9) Part-time tutorship under the coaching organisation of the Institute.
- (10) Valuation of papers, acting as paper-setter, head-examiner or a moderator, for any examination.
- (11) Editorship of professional journals.
- (12) Acting as Surveyor and Loss Assessor under the Insurance Act, 1938 provided they are **otherwise eligible**.

(13) Acting as recovery consultant in the banking sector

- (14) Owning agricultural land and carrying out agricultural activity (w.e.f. August 9th, 2008).

Specific Resolution - Members of the Institute in practice may engage in the following categories of business or occupations, after obtaining the specific and prior approval of the Council in each case:

- (1) Full-time or part-time employment in business concerns provided that the member and/or his relatives do not hold "substantial interest" in such concerns.
- (2) Full-time or part-time employment in non-business concern.
- (3) Office of managing director or a whole-time director of a body corporate within the meaning of the Companies Act, 1956 (now Companies Act, 2013).
- (4) Interest in family business concerns (including such interest devolving on the members as a result of inheritance / succession / partition of the family business) or concerns in which interest has been acquired as a result of relationships and in the management of which no active part is taken.
- (5) Interest in an educational institution.
- (6) Part-time or full-time lectureship for courses other than those relating to the Institute's examinations conducted under the auspices of the Institute or the Regional councils or their branches.
- (7) Part-time or full-time tutorship under any educational institution other than the coaching organization of the Institute.
- (8) Editorship of journals other than professional journals.
- (9) Any other business or occupation for which the Executive Committee considers that permission may be granted.

However, it is open to the Council to refuse permission in individual cases though covered under any of the above categories. For the purpose of the above resolution:

- (i) the expression “relative”, in relation to a member, means the husband, wife, brother or sister or any lineal ascendant or descendant of that member;
- (ii) a member shall be deemed to have a “substantial interest” in a concern:
 - (a) In a case where the concern is a company, if its shares (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profit) carrying not less than 20% of voting power at any time, during the relevant years are owned beneficially by such member or by any one or more of the following persons or partly by such member and partly by one or more of the following persons:
 - (i) one or more relatives of the member;
 - (ii) one or more partners and/or their relative;
 - (iii) any concern in which any of the persons referred to above has a substantial interest.
 - (b) In the case of any other concern, if such member is entitled or the other persons referred to above or such member and one or more of the other persons referred to above or persons of such number and / or are more sections of such persons are entitled in the aggregate, at any time during the relevant years not less than 20% of the profits of such concern.

Attention of the members is also invited to para 3 of the above Resolution relating to the holding of office of a managing director or a whole-time director in a company. In such cases, a member can accept the office of a managing director or a whole-time director only after obtaining, the specific and prior approval of the Council. Attention of the members is also invited to the provisions of Section 2(26) of the Companies Act, 1956 (now Section 2(54) of the Companies Act, 2013) under which even where a person is not designated as a managing director or a whole-time director, he can be deemed to be a managing director or a whole-time director if he is entrusted with the whole or substantially the whole of the management of the affairs of the company. It may be pointed out that a member cannot accept and hold the office of a managing director or a whole-time director in a company if the member and/or his partners and relatives hold substantial interest in such a company.

The Council has considered the question of permitting members in practice to become a Director, Managing Director, full time/Executive Director etc. and related issues and the following decisions have been taken.

As regards the question of permitting member in practice to be a Director, Promoter/Promoter-Director, Subscriber to the Memorandum and Articles of Association of any company including a board managed company, it was decided that -

(a) Director of a Company

- (i) The expression “Director Simplicitor” means an ordinary / simple Director.
- (ii) A member in practice is permitted generally to be a Director Simplicitor in any company including a board-managed company and as such he is not required to obtain any specific permission of the council in this behalf irrespective of whether he and / or his relatives hold substantial interest in that company.

22.50 Advanced Auditing and Professional Ethics

A question arises, whether the auditor of a Subsidiary Company can be a Director of its Holding Company-

The Ethical Standard Board (ESB) noted that, in terms of Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 a Chartered Accountant in practice can not engage (unless permitted by the Council so to engage) in any business or occupation other than the profession of Chartered Accountant but he can be a director of a Company (not being a managing director or whole time director) wherein he or any of his partners is not interested in such company as an auditor. The Board further noted that Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence. In view of the above, the Board, via a clarification, decided that the auditor of a Subsidiary Company can't be a Director of its Holding Company, as it will affect the independence of an auditor.

(b) Promoter/Promoter Director - There is no bar for a member to be a promoter / signatory to the Memorandum and Articles of Association of any company. There is also no bar for such a promoter / signatory to be a Director Simplicitor of that company irrespective of whether the object of the company include areas which fall within the scope of the profession of chartered accounts. Therefore members are not required to obtain specific permission of the Council in such cases.

Item Nos. 4 & 5 of the Specific Resolution would be equally applicable to member carrying out the activities referred to therein in his capacity as Karta / representative of HUF provided he is not actively engaged in carrying on such activities.

CASE STUDY

CA Ram who is a leading Income Tax Practitioner and consultant in Jaipur is also trading in derivatives.

As per Clause (11) of Part I of First Schedule of CA Act, 1949, a Chartered Accountant is deemed to be guilty of professional misconduct if he "engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage".

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case CA Ram is engaged in the occupation of trading in derivatives which is not covered under the general permission.

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of CA Act, 1949.

Some of the decisions of the Council/High Courts on this clause are given below:

A chartered accountant in practice entered into partnership with persons who were not the members of the Institute, for the purpose of carrying on business. The share of the chartered accountant in the profit and losses was 25%. He was to take part in the business and was

entitled to represent the firm before Govt. authorities etc. He was operating the Bank account of the firm was receiving moneys from the customers and was also looking after the affairs of the partnership. Held he was guilty of professional misconduct under the clause, as he was engaged in the business, without the permission of the Council. [*K.S. Dugar (1980)*]

A member in practice was authorised by a resolution of the Board of Directors of a company held on 4.9.81 to look after the day to do affairs of the company and other more than 51% the said company. Later on 8.5.82, he applied to the Council for permission to hold the office of the Executive Chairman of the said company. It was held on the basis of facts and circumstances of the case that during the period 4.9.81 to 8.5.82 the member had engaged himself in 'other occupation' without the permission of the Council and was found guilty in terms of this Clause. [*M.K. Abrol and S.S. Bawa vs. V.P. Vijn (1988)*]

Where a Chartered Accountant who had held a salaried employment as an Assistant Manager (Finance & Accounts) in addition to the practice of chartered accountancy without obtaining permission of the Institute as required was held guilty under Clause (11) of Part I of First Schedule. [*Anil Kumar (1994)*]

Where a Chartered Accountant while practicing as a chartered accountant had engaged himself in other occupation as an LIC agent in another name. Held that he was guilty Clause (11) of First Schedule. [*C.I.T. (Admn.) vs. H.M. Giriya (1996)*]

Where a chartered Accountant had offered to help the Complainant in disposing of odd lot share holding, sold them at much lower rate than he had sent of the Complainant notes etc. and the said chartered accountant was personally involved in the share transfer and broker's business besides his professional activities. Held that he was guilty under Clause (11) of Part I.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 12(b), 14(a), 15(b), 16(d), 18(b), 23(a), 25(b), 33 of the Practice Manual.]

Clause (12) Allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

The above clause prohibits a member from allowing another member who is not his partner to sign any balance sheet, profit and loss account or financial statements on his behalf or on behalf of his firm.

This clause is to be read in conjunction with Section 26 of the Chartered Accountants Act, 1949 which stipulates that 'No person other than a member of the Institute shall sign any document on behalf of a Chartered Accountant in practice or a firm of Chartered Accountants in his or its professional capacity'.

The term 'financial statement' for the purposes of this clause would cover an examination of the accounts or of financial statements given under a statutory enactment or otherwise. A report, however, may cover a wider range of documents but in the context in which it is used in this clause, it would mean only a report arising out of a professional assignment undertaken by him or his firm and submitted by him or his firm to the client(s) or where so required, to an outsider on behalf of himself or on behalf of the firm. The subject matter of report should be the

22.52 Advanced Auditing and Professional Ethics

expression of a professional opinion whether, financial or non-financial. The financial statements and the reports referred to in this clause obviously means the financial statements and reports as ultimately finalized and submitted to the outside authorities.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause:

- (i) Issue of audit queries during the course of audit.
- (ii) Asking for information or issue of questionnaire.
- (iii) Letter forwarding draft observations/financial statements.
- (iv) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.
- (v) Acknowledging and carrying on routine correspondence with clients.
- (vi) Issue of memorandum of cash verification and other physical verification or recording the results thereof in the books of the clients.
- (vii) Issuing acknowledgements for records produced. Raising of bills and issuing acknowledgements for money receipts.
- (ix) Attending to routine matters in tax practice, subject to provisions of Section 288 of Income Tax Act.
- (x) Any other matter incidental to the office administration and routine work involved in practice of accountancy.

It is also clarified that where the authority to sign documents given above is delegated by a chartered accountant or by a firm of chartered accountants the fact that the documents have not been signed by a chartered accountant is not a defence to him or to the firm in an enquiry relating to professional misconduct.

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

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 18(c), 27(a), 35(a) of the Practice Manual.]

PART II - Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person-

Clause (1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.

A member of the Institute in service is deemed to be guilty of professional misconduct, if he is an employee of any company, firm or person and during that course whatever emoluments he receives, if he either pays or allows to pay or agree to pay any part or share thereof whether directly or indirectly. However, this clause does not restrict such sharing or commitments

among relatives, dependents, friends etc., if there is no relationship in procuring or retaining the job and payment is not a consideration for job procurement or retainership.

The clear verdict of this clause is that job must be procured and retained with own professional capabilities and not by any financial deal impairing professional dignity.

Clause (2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

This clause restricts to accept or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification. The objective is that when a member is in employment, he must maintain high level of ethics and should not accept any other amount from anyone for which he is not entitled from employer under contractual agreement of service.

[Note: A member in the foregoing circumstances would be guilty of misconduct regardless of the fact that he was in whole-time or part-time employment or that he was holding Certificate of Practice along with his employment.]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 35(c) of the Practice Manual.]

PART III - Professional misconduct in relation to members of the Institute generally

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

Clause (1) not being a fellow of the Institute, acts as a fellow of the Institute.

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

Clause (11) of Part I and Clauses (1) and (3) of Part III where a Chartered Accountant had not disclosed to the Institute at any time about his engagement as a proprietor of a non-chartered accountant's firm while holding certificate of practice and had not furnished particulars of his engagement as Director of a company despite various letters of the institute which remained unreplyed. Held that he was guilty under Clause (11) of Part I and Clauses (1) and (3) of Part III of the First Schedule. *[P.S. Rao (1992)]*

Where a Chartered Accountant had continued to train an articled clerk though his name was removed from the membership of the Institute and he had failed to send any reply to the Institute asking him to send his explanation as to how he was training as his articled clerk when he was not a member of the Institute. Held that he was guilty under Clause (2) of Part III of the First Schedule. *[S.M. Vohra (1992)]*

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 14(c), 23(d), 35(b) of the Practice Manual.]

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

Any member of the Institute, in the course of procurement of professional work from another Chartered Accountant or from any other source provides or renders any information which he knows to be false through any documents, or acts (like tenders, enquiries, response to advertisement, CV type write ups etc.), he would be deemed to be guilty of professional misconduct under Clause (3), Part III of First Schedule.

PART IV- Other misconduct in relation to members of the Institute generally

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

Clause (1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.

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

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 16(b), 25(c), 28(d), 31(a) of the Practice Manual.]

These Clauses (1) & (2) are self explanatory and any of the member of the Institute is found guilty by any civil or criminal court and prosecuted for an imprisonment in an offence involving moral turpitude or his acts bring disrepute to the profession or the Institute, irrespective of the fact whether such acts are related to profession or not, such member will be deemed to be guilty of other misconduct in Part IV of First Schedule.

The important point to note is that if imprisonment tenure exceeds six months, this case will be covered in the Clause of Part III of Second Schedule.

22.8.2 The Second schedule: Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the Schedule, he shall place the matter before the Disciplinary Committee.

Part I - Professional misconduct in relation to chartered Accountant in practice

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

Clause (1) Discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.

An accountant in public practice has access to a great deal of information of his client, which is of a highly confidential character. It is important for the work of an accountant and for maintaining the dignity and status of the profession that he should treat such information as having been provided to him, only to facilitate the performance of his professional duties for which his services have been engaged. To divulge such information would be a breach of

professional confidence, which may give rise to the most serious consequences, even to an action by the client for the loss suffered by him through such a breach. But for this confidence that the public has developed in the integrity of accountants, it would not be possible for a person in a similar trade or industry to appoint the same accountant. The accountant's duty not to disclose continues even after the completion of his assignment.

If disclosure is required as a part of performance of professional duty by a practicing member in relation to a client, the fact that such performance is required by the client would itself amount to the client consenting to such disclosure. Thus, a member in practice submitting information to, say, exchange control authorities, while performing his professional duties cannot be considered to have made disclosure without the aforesaid consent. But, in all cases, the request or the initiative that the members do prefer the service, which would entail such disclosure, must come from the client in relation to whose affairs the disclosure would be entailed.

If disclosure is required in other cases, it would be necessary to ensure that the consent of the client is given by a person who is competent to accord such consent. Thus, in the case of a sole proprietary concern, the consent may be given by the proprietor or his constituted attorney who is legally empowered to give such consent. In the case of partnership firm, since in turn, every partner has the authority to bind the firm by his acts, the consent may be given by any partner. In the case of a company, by virtue of section 179 of the Companies Act, 2013, the Board of Directors is empowered to do all that the company in a general meeting may do unless a resolution by the company in general meeting is required by the Act or by the Memorandum or Articles of the company. Hence, the consent may be given by the Managing Director if the powers of the Board of Directors are delegated to him comprehensively enough to include the power to give such consent, but if the powers of the Board of Directors are not so delegated, the consent should be obtained by means of resolution of the Board of Directors of the Company.

An auditor is not required to provide the client or other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client. The above clarification has been published in April, 2000 issue of the Journal, 'The Chartered Accountant'.

It is not possible to set out all the circumstances under which disclosure of information may be required by law. If under any legal compulsion and if it is not legally permissible to claim privilege under the Evidence Act, 1872 (Section 126), the disclosure made by a member of such information may not be considered as misconduct. However, such matters involve niceties of law and expert legal advice may be sought prior to, such disclosure.

22.56 Advanced Auditing and Professional Ethics

The only circumstance in which this duty of confidence may give rise to a difficulty is where the accountant has reason to believe that the client has been guilty of some unlawful act or default. This matter is of special significance in the case where the client is guilty of tax evasion.

Further, students may note that as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Role of chartered accountants in relation to unlawful acts by their clients -

- (1) The question of the member's liability when he is not directly involved in tax frauds committed by his client but he discovers such fraud in the course of his professional work, the action recommended to be taken by him is indicated below. These recommendations are generally in line with similar recommendations made by the Institute of chartered accountants in England and Wales for the guidance of its members.
- (2) The recommendations below are based on the following premises:
 - (a) No duty is cast on a member, whether by Section 44 of Criminal Procedure Code, or by any other enactment, to inform the Income tax Authorities about taxation frauds by his client of which he comes to know during the course of his professional work.
 - (b) Under Section 126 of the Evidence Act, a barrister, attorney, pleader or *Vakil* is barred from disclosing except with the express consent of his client, any communication made to him in the course of and for the purpose of his employment or to state the contents or conditions of any document with which he has become acquainted in such course. The proceedings before the Income tax authorities are judicial proceedings and the assessee is authorized to be represented by a chartered accountant. The privilege given and the restrictions imposed by Section 126 apply as between the client and the member as the member is the client's attorney. Nothing in Section 126 shall protect from disclosure of any fact observed by a barrister, pleader, attorney or *Vakil* in the course of his employment of such showing that any crime or fraud has been committed since the commencement of his employment.
 - (c) Subject to the above, it is not the duty of a member to shield a client from the consequences of his tax frauds; on the contrary it is guiding principle of professional conduct to discourage tax evasion.
- (3) The paragraphs that follow apply to intentional suppressions or misstatement by the client in his tax returns. If there is a genuine mistake or inadvertent omission, it is presumed that the client would not have any objection to make a complete disclosure to the tax authorities.
- (4) If the fraud discovered by the member relates to the accounts or tax matters of the client for past year(s) for which the client was not represented by the member, the client should be advised to make a disclosure. The member may, however, continue to act for the client in respect of current matters, but is under no obligation so to continue. It is assumed that the past fraud does not affect in any way the current tax matters, and the member should be extra careful to ensure that past behaviour is not reflected in current matters.

- (5) If the fraud relates to accounts etc., examined by the member and reported upon, on the basis of which the tax assessment in the past has been made, or is currently to be made, the client should be advised to make a complete disclosure. If the client should refuse, he should be informed that the member would be entitled to dissociate himself from the case, and that, further, he would inform the authorities that the accounts prepared by him and/or reported upon by him are unreliable, on account of certain information since obtained. He should then make such a report to the authorities. But the information subsequently obtained should not as such be communicated to the authorities, unless the client consents in writing.
- (6) Normally, if disclosure is consented to by the client it should be made immediately. But if the suppression is trivial, the disclosure may be made when the current return is submitted. But if there is any possibility that the collection of tax would be prejudiced, on account of the client disposing of his property or removing his person from the jurisdiction of the Income-tax authorities the postponement of disclosure would be improper.
- (7) If the suppression etc. relates to accounts or returns currently being prepared, the member should advise the client to make full disclosure in the accounts and/or return, and should the client refuse, he should make full reservation in his report, and should not associate himself with the return.
- (8) If the employment of the member is dispensed with before the accounts are completed or are reported on, or the return is submitted, no further duty regarding disclosure etc. rests on the member.
- (9) The suppression may relate to accounts, which are not prepared and/or reported upon by the member, e.g. personal income, from investments other than business investments etc. The client may refuse full disclosure in the tax return but still wish that the member should continue to prepare and/ or report on his business accounts, though this is quite unlikely in practice. If so requested, the member may continue to do so, but is under no obligation so to do.
- (10) It should be impressed on the client that:
 - (a) While disclosure may entail only monetary penalties, nondisclosure and subsequent discovery thereof may entail imprisonment and fine, in addition to penalties.
 - (b) Any intimation by the member to the Income tax authorities that the member dissociates himself from the case is certain to start investigation by them in the whole matter.
- (11) The Income-tax authorities may summon the member for the purpose of examining him on oath, under Section 131(1) of the Income tax Act. The immunity from disclosure afforded by Section 126 of the Evidence Act, and the extent of such immunity are questions, which involve niceties of law, and expert legal advice should be sought in the matter. The refusal of the member to disclose may be taken down, and he may be required to certify it on oath.
- (12) Production of books of account and other documents may be called for under Section 131(1). Here also the protection offered by Section 126 of the Evidence Act, is a matter for expert legal advice.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 6(a), 14(b) of the Practice Manual.]

Clause (2) If he certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice.

The above clause restrains a member from subscribing to the report on a financial statement so long as it has not been examined by him or by a partner or an employee of his firm or by another chartered accountant in practice. It has been introduced to ensure that the work entrusted to him has been carried out by the member either directly or under his supervision before he renders his report.

An exception however has been made in respect of an examination carried out by another chartered accountant in practice. This enables two or more members to accept a joint assignment or enables a member also to carry out the examination of financial statements by or with the assistance of all or either any chartered accountant in practice.

Where the joint auditors are appointed, the work is normally divided among themselves in terms of identifiable units or areas, or with reference to the items of liabilities, or income or expenditure or to the period of time etc. Such division should be adequately documented and communicated to the auditee.

In the course of his work, where a joint auditor comes across matters requiring discussion with or application of judgement by the joint auditors, he must communicate to the other joint auditors before submission of the report.

In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:

- (a) In respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- (b) In respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution by the joint auditor concerned;
- (c) In respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- (d) For examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- (e) For ensuring that the audit report complies with the requirements of the relevant statute.

Each joint auditor should decide for himself the appropriateness of using test checks or sampling, the nature, timing and extent of audit procedures to be applied in relation to the work allotted to him.

Obtaining and evaluating the information and explanations from the management is the joint responsibility of the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In case of distribution of the responsibility, the liability of the joint auditors is limited to the area allotted to that auditor.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 24(b), 25(d) of the Practice Manual.]

Clause (3) Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

The Council has issued Standard on Assurance Engagements (SAE) 3400, "The Examination of Prospective Financial Information", which is effective in relation to reports on projections/forecasts, issued on or after April 1, 2007. Pursuant to the issuance of this Standard, the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts, issued in September, 1982 stands withdrawn. The guidance provided in this Standard is in line with the provisions of Clause (3) of Part I of the Second Schedule to the Chartered Accountants Act, 1949. As per the opinion of the Council while finalising the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts at its 100th meeting held on 22nd through 24th July 1982, a chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts. The Council has further opined that the same opinion would also apply to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as the auditor does not vouch for the accuracy of the projection. Further, the attention of the members is drawn to "Guidance Note on Reports in Company Prospectuses (Revised)" issued by the Council in October, 2006. This Guidance Note provides guidance on compliance with the provisions of the Companies Act and the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000 relating to the reports required to be issued by chartered accountants in prospectus/statement in lieu of prospectus issued by the companies for the offerings made in India.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 3(d), 16(a) of the Practice Manual.]

Clause (4) Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

In this connection attention of members is also invited to Chapter IV of Council Guidelines No. 1-CA(7)/02/2008 dated 8th August, 2008. The said guidelines state that a member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons, who are his "relatives" within the meaning of Accounting Standard

22.60 Advanced Auditing and Professional Ethics

(AS-18) has/have either by themselves or in conjunction with such members, a substantial interest in the said business or enterprise.

Many new areas of professional work have been added, e.g., Tax Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of banks and financial institutions, audit of stock exchange, brokers etc. The Council wishes to emphasize that the aforesaid requirement of Clause (4) are equally applicable while performing all types of attest functions by the members. Some of the situations which may arise in the applicability of Clause (4) are discussed below for the guidance of members:

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

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

- (i) An enterprise/concern of which a member is either an owner or a partner. The holding of interest in the business or enterprise by a member himself whether as sole-proprietor or partner in a firm, in the opinion of the Council, would affect his independence of mind in the performance of professional duties in conducting the audit and/or expressing an opinion on financial statements of such enterprise. Therefore, a member should not audit financial statements of such business or enterprise.
 - (ii) Where the partner or relative of a member has substantial interest: The holding of substantial interest by the partner or relative of the member in the business or enterprise of which the audit is to be carried out and opinion is to be expressed on the financial statement, may also affect the independence of mind of the member, in the opinion of Council, in the performance of professional duties. Therefore, the member may, for the same reasons as not to compromise his independence, refrain from undertaking the audit of financial statements of such business or enterprise.
- (2) Where the member or his partner or relative is a director or in the employment of an officer or an employee of the company.

Section 141 of the Companies Act, 2013 specifically prohibits a member from auditing the accounts of a company in which he is an officer or employee. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally applicable in those situations also. Therefore, the Council's views are clarified in the following situations.

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

The Council has clarified that the members are not permitted to write books of account of their auditee clients.

A statutory auditor of a company cannot also be its internal auditor, as it will not be possible for him to give independent and objective report.

A member should satisfy himself before accepting an appointment as an auditor of an entity that his appointment is in accordance with the statute governing the entity. In case the entity is constituted under a trust deed / instrument, the member should satisfy whether his appointment is valid according to the instrument constituting the entity and rules made hereunder. In case the appointment is to be authorized by the regulatory authorities such as in the case of cooperative societies, trusts etc. then the member must satisfy whether such regulatory authorities have authorized the managing committee of the society / trust for appointment of the auditors. In a case where any entity is being managed by a Managing Committee or Board of Trustees or Board of Governors by whatever name called he should ensure that his appointment is duly made by a resolution passed of such Managing Committee or Board of Trustees of Board of Governors. Even in case of partnership or sole proprietary, the member must ensure that a letter of appointment/ engagement is given by a financial statement before he accepts the assignment.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 4(a), 6(b), 21(d), 25(b), 30(c) of the Practice Manual.]

Clause (5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement not misleading where he is concerned with that financial statement in a professional capacity.

It may be observed that this clause refers to failure to disclose a material fact, which is known to him, in a financial statement reported on by the auditor. It is obvious, that before a member could be held guilty of misconduct, materiality has to be established. The determination of materiality has been provided in SA 320, "Materiality in Planning and Performing an Audit".

It should be borne in mind that there may be cases where an item may not be material from the point of view of the balance sheet, but may have material significance in relation to the profit and loss account for that year and vice-versa. It is therefore essential that care should be taken to ensure that the aspect of materiality should be judged in relation to both the balance sheet and the profit and loss account.

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

Some of the decisions of the Courts on this clause are briefly given below-

Where a Chartered Accountant failed to report to the shareholders of a company about the non-creation of a sinking fund in accordance with the Debenture Trust Deed and did not make clear that the amounts shown as towards sinking fund were borrowed from the managing agents of the company-Held, that the chartered accountant was duty bound to see that the nature and

22.62 Advanced Auditing and Professional Ethics

subject matter of the charge over a security and the nature and mode of valuation of the sinking fund investment were disclosed in the Balance Sheet in accordance with Form F and he was found guilty of misconduct. [*Davar & Sons Ltd. vs M.S. Krishnaswamy (1952)*]

Where a Chartered Accountant failed to examine how debts became bad and were written off- Held he was guilty under Clause (5). [*A. Doraiswami/ Naidu-vs. P.M. Raghavendra Rao (1965)*]

Where a Chartered Accountant had not disclosed the fact that a large amount of loan have been given out of the funds of an Employees Provident Fund to the Employer Company in contravention of the Rules of the Provident Fund and had failed to report on the default in clearing the cheques received in re-payment of the loan. Held by the High Court that he was not guilty of any non-disclosure to the individual subscribers of the Provident Fund because he owed no duty to disclose to them and he was well within his rights to have disclosed the irregularities to the trustees themselves and to the company which had appointed him. Held by the Supreme Court on appeal that it was no defence for the chartered accountant to say that he had disclosed the irregularities to the company as it was his duty to have made a disclosure thereof to the beneficiaries of the Provident Fund in the statement of accounts signed by him as the legal position of the auditor in the present case was similar to that of the auditor appointed under the Companies Act. He was therefore guilty of professional misconduct under Clause (5). [*Kishori Lal Dutta vs-P.K. Mukherjee (1968)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 6(c), 17(c), 19(a), 22, 28(b) of the Practice Manual.]

Clause (6) Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

This clause refers to failure on the part of a member to point out in his report a material misstatement appearing in a financial statement and he has knowledge of the same. Here also, it is obvious, that before a member could be held guilty of misconduct, materiality has to be established and the observations made under the preceding Clause (5), in this connection, will equally apply to this clause.

Some of the decisions of the Courts on this clause are briefly given below-

A Company did not provide for depreciation as required by Section 205 and Section 350 of the Companies Act, 1956 (now Section 123 read with Schedule III of the Companies Act, 2013) and although the Chartered Accountant was aware that the Company had underprovided depreciation, he did not bring out this fact in his report- Held the Chartered Accountant was guilty of professional misconduct under the clause. He had failed to disclose a material fact known to him but disclosure of which was necessary to make the financial statement not misleading.

Where a Chartered Accountant prepared a balance sheet of a firm and subsequently prepared statement regarding the state of affairs of the firm without taking into account the balance sheet already prepared by him showing a lesser amount by way of opening stock and a lesser amount to the credit of the proprietor and subsequently when he was called upon by his client to prepare a fresh balance sheet and profit and loss account for the same year so that it should tally with the statement of affairs prepared by him he did so without reference to the actual account books

but on instruction of the client, and as such it was a false and incorrect balance sheet. Held, he was guilty under Clauses (5) & (6). [*Attorney General of Kenya-vs-V.B. Joshi (1968)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 17(c) of the Practice Manual.]

Clause (7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

Though very simply worded, it is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence. The meaning and significance of this clause is well contained in the following passage quoted from the Judgement of the Karnataka High Court in a disciplinary case which came before it in 1977.

It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

Professional misconduct is a term of fairly wide import but generally speaking, it implies fairly serious cases of misconduct of gross negligence. Negligence per se would not amount to gross negligence in the case of minor errors and lapses, which do not constitute professional misconduct and which, therefore, don't require a reference to the Disciplinary Committee, the Council would nevertheless bring the matter to the attention of its members so that greater care may be taken in the future in avoiding errors and lapses of a similar type".

CASE STUDY

CA Chiranjiv who conducted ABC audit of a Haryana daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

In the instant case, CA Chiranjiv did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential. Further certification of circulation figures based on statistical information without cross

verification with financial records amounts to gross negligence and failure to exercise due diligence.

Hence, CA Chiranjiv is guilty of professional misconduct as per Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949.

Some of the decisions of the Courts on this clause are briefly mentioned below:

Where a Chartered Accountant failed to indicate the mode of valuation of investments in shares as required by the Companies Act and also to draw attention to the inclusion of uniforms in the depreciation account- Held that he was guilty under Clause (7). [*M.C. Poddar vs-P.S. Sodhbans* - page 259 of Vol. I of the Disciplinary Cases and page 554 of March 1954 issue of the Institute's Journal-Judgement delivered on 1st April, 1954].

Where a Chartered Accountant certified the circulation of a newspaper based on the statistic record but stated in his certificate that he had given it after examination of the books of account without verifying that the books of account and the statistical records agreed and also without taking into account the return of copies unsold. Held that he was guilty of gross negligence. [*V.K. Madhava Rao (1956)*]

Where a certificate issued by a Chartered Accountant under Regulations 7(c) & 7(d) (i) of Part I (d) the First Schedule to the Insurance Act, 1938 was not correct, as the company had granted loans on policies which had already lapsed for non-payment of premium and also the claims in respect of two policies which had matured were not included in estimated liability in respect of outstanding claims shown in the Balance Sheet- Held he was guilty under Clauses (7) & (8). [*Controller of Insurance vs H. C. Das (1957)*]

Where a Chartered Accountant, appointed as auditor of the Madras branch of a limited company in Bombay was charged with failure to report to the Bombay office that some entries in the bank pass book had not been passed through the cash book of the branch. Held he was guilty of gross negligence. The High Court observed that a small fee paid to the respondent should not come in the way of his doing duty without fear or favour, although it involved unpleasant consequence namely, he might not be appointed again. [*The Fairdeal Corporation Ltd. Bombay vs K. Gopalakrishna (1957)*]

A certificate issued by a Chartered Accountant to a proprietor of a firm in respect of the turnover of betel nuts to enable the firm, which was not dealing in betel nuts, to obtain import license without checking the books and documents himself, but relying on his articled clerk for its correctness. Held he was guilty of gross negligence. [*Sunder Lal Fatehpuria in Re: page 591 of Vol. III of the Disciplinary Cases and page 224 of January, 1959 issue of the Institute's Journal-Judgement delivered on 14th November, 1958*]

Where a Chartered Accountant failed in his duty to check the bank balances with the pass books of the banks and failed to obtain certificates of balances from the bankers in respect of those balances. The Council found him guilty of misconduct under Clauses (7) & (8) of Part I of the Second Schedule. Held there being no proof of dishonesty or volume *malafide* on the part of the Chartered Accountant and in view of the circumstances of the case, the High Court took no more serious view of the matter than to express disapprobation of the conduct of the Chartered Accountant in the form of admonition. [*Company Law Administration-vs-D.B. Kulkarni (1960)*]

In the course of some investigation of the affairs of a bank on liquidation, it was found that the authorities of the bank failed to disclose the total indebtedness of the directors in the balance sheet and to report on the numerous alterations and fictitious entries in the books of accounts of the bank. Held that no auditor could escape from personal liability by taking shelter under the misconduct of his own employees. There was nothing to indicate the status, qualifications or capacity of the assistants. Under the circumstances, the conduct of the Chartered Accountant in abdicating his functions to his subordinates amounted to gross negligence. [*Superintendent of Police Madras vs M. Rajamany (1961)*]

Where a Chartered Accountant had placed implicit reliance on his paid assistant who took absolutely no step whatsoever to check the cash balances facilitating and resulting, in serious defalcations. Held he was guilty under Clauses (5), (7) (8) and (9). [*D. C. Sopariwala (1968)*]

Where a certificate issued by a Chartered Accountant to the Joint Chief Controller of Imports & Exports, Calcutta stating that a firm had exported a certain quantity of onions during a certain period contained false and inaccurate particulars in respect of three items of invoice value the particulars themselves related to exports not by this firm but by two other firms. Held he was guilty of the charge of gross negligence. [*The Chief Controller of Exports vs-G.P. Acharya (1962)*]

Where a Chartered Accountant signed the accounts of an institution subject to separate notes. Held he was guilty of gross negligence. In the view of the High Court, the essential part was the separate notes. Any one going through his report would at least assume that those notes when prepared and were ready at the time when the report was signed by him. It could not be supposed that those notes were not in existence at that time and were written at some later date on some facts, which were still to be verified or ascertained. His act, though not suffering from bad or vicious intention, was still an act of gross negligence. [*Hitkarini Mahavidyalaya, Jabalpur vs P.C. Madan (1963)*]

Where a chartered accountant gave clean reports on the balance sheets whereas the reports on the special audit conducted subsequently revealed certain irregularities which amounted to failure to examine the pass book and to verify the cash balance. Held he was guilty under Clause (7). [*Director of Accounts, Gujarat State, Ahmedabad vs K.D. Patel (1968)*]

Where a Chartered Accountant had not completed his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard. Held, he was guilty of professional misconduct under Clause (7). [*Qaroon Trading & Finance Pvt. Ltd.- vs Luxmi Narain Saxena and Jitendera Mohan Chadha (1969)*]

Where a Chartered Accountant failed to exercise sufficient care and diligence in his professional responsibilities in not checking the cash memos and not verifying the alterations in the trial balance with the original books in respect of one company and in not checking the journal entries and the final figures of the balance sheet with the general ledger in respect of another company. Held, he was guilty under Clause (7). [*Messrs. O. M. Agency Private Ltd. & Messers. Oriental Mercantile Distributors Private Ltd. Surendra Sastry (1971)*]

22.66 Advanced Auditing and Professional Ethics

In his audit report of a school, the auditor failed to point out wrong and misleading entries and a sum of ₹ 7,000/- on account of reserve fund did not find a place at all in the original statement sent to the school. The correction slip alleged to be sent by the Chartered Accountant was never received by the school. The Chartered Accountant had not proved that the correction slip was sent to the school. Held the Chartered Accountant was guilty of gross negligence in the conduct of professional duties and his conduct was quite unbecoming of a professional person entrusted with responsibility of dealing with the accounts. [*B.L. Shoulder vs-M.K. Deb (1976)*]

A Chartered Accountant adopted arbitrary valuation of closing stock and no verification at all was done by him. Further he accepted the capitalization of a large sum of expenditure which was in the nature of revenue. He had merely adopted an *ad-hoc* basis in deciding upon capitalization of expenditure and failed to apply his mind and bring to bear on the subject the due diligence and care expected of a member of the profession. Held, the Chartered Accountant was guilty of gross negligence in the performance of his duties. [*B. Shantharam Rao (1977)*]

A Chartered Accountant was charged under Clauses (5), (6), (7) and (8) of Part I of Second Schedule in regard to a loss of ₹ 1.84 lakhs in a bank of sale of some investments out of which only a sum of ₹ 21,500 was written off by the bank. The value of investment in the balance sheet was inflated and it did not exhibit the correct position and the profit and loss account did not show a true balance of profit and loss. Held, the respondent was guilty of misconduct so as to render him unfit to be a member of the institute. [*B.S. Waierker (1957)*]

Where a Chartered Accountant issued two different certificates of circulation of a daily for one and the same period showing different figures in respect of the number of copies printed and circulated. Held, he was guilty under Clauses (7) and (8). [*Registrar of Newspapers for India vs P.K. Mukherji (1971)*]

A Chartered Accountant had failed to detect a fraud committed by the accountant of a canteen which could have been detected if he had checked the castings of the cash books and also checked the 'contra' entries of the bank and cash columns of the cash books. Held, he was guilty of professional misconduct under Clauses (7), (8) and (9). [*Air Commodore Dilbagh Singh vs C.G. Apte (1976)*]

Where a Chartered Accountant failed to make a reference in the "Income Certificates" prescribed by the ABC to the report which he had separately submitted to the newspaper concerned which did represent the correct state of affairs in all respects but which was not sent by the newspaper to the Bureau. Held, he was guilty under Clauses (7) and (9). [*Audit Bureau of Circulations Ltd., vs A.D. Shinde (1968)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 13(c), 15(d), 24(b), 25(d), 31(c) of the Practice Manual.]

Clause (8): Fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

It is expected of a Chartered Accountant to express his opinion on the truth and fairness of statements of accounts after examining their authenticity with reference to information and explanations given to him. A Chartered Accountant must determine the extent of information,

which, should be obtained by him before he expresses an opinion on the financial statements submitted to him for report.

The accountant should not express an opinion before obtaining the required data and information. The latter part of the clause enjoins that where due to inadequacy of information or data the report has to be circumscribed to an extent that it would cease to be of any expression of a categorical opinion, the auditor should clearly express his disclaimer in no uncertain terms. For example, if the auditor has not seen any evidence of the existence and/or valuation of the investment which constitute the only asset of a company, he should not say that:

“Subject to the verification of the existence and value of the investments the balance sheet shows a true and fair view etc.”

On the other hand he should say that-

“As we have been unable to verify the existence and value of the investments of the company, we are unable to state whether the balance sheet shows a true and fair view etc.

Some of the decisions of the Courts on this subject are briefly presented below:

A Chartered Accountant without examination of stock register and other relevant matters issued a wrong consumption certificate on the basis of which licence of higher value, for which the unit was not entitled, was issued by Controller of Imports & Exports. The examination done by the Chartered Accountant was so restricted that he could not have obtained the information necessary to warrant the expression of an opinion regarding consumption of raw material and components. Held the chartered accountant was guilty of professional misconduct under Clause (8). [*T.S. Vaidyanatha Iyer (1977)*]

Where a Chartered Accountant relying on the work of the internal auditor of a company qualified his report that the books of account and the supporting vouchers had been examined by the internal auditor of the company, the Council taking the view that the qualification amounted to an exception sufficiently material to negate the expression of an opinion, found him guilty, of misconduct under the latter part of Clause (8). As a general rule, a statutory auditor would be guilty under this clause, if he performed his work so recklessly as to give his report without looking into the books of account of a company, on the basis of the work of the internal auditor whose opinion turned out to be false. [*J.C. Chandhok (1964)*]

Where a Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for. Held he was guilty under Clause (8). [*Registrar of Newspapers for India vs K. Rajinder Singh (1971)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 6(d), 23(b), 24(b), 28(c), 29(a) of the Practice Manual.]

Clause (9) Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

This clause implies that the audit should be performed in accordance with “generally accepted procedure of audit applicable to the circumstances” and if for any reason the auditor has not been able to perform the audit in accordance with such procedure, his report should draw attention to the material departures from such procedures. What constitutes “generally accepted audit procedure” would depend upon the facts and circumstances of each case, but guidance is available in general terms from the various pronouncements of the Institute is issued by way of statements and Guidance Notes and SAs to members.

Members are also advised to refer to the ISA's issued by the International Auditing Practices Committee of IFAC.

An auditor of a company is appointed by the shareholders to perform certain statutory functions and duties and it is expected of him that he will in fact, perform these functions and duties. The failure to perform a statutory duty in the manner required is not excused merely by giving a qualification or reservation in auditor's report. For example, if an auditor fails to verify the cash balance in circumstances where such verification was necessary, feasible and material, it is not sufficient for him merely to state in his report that he did not verify the cash balance in circumstances when giving any reservations or qualifications in the auditor's report as required under this clause, a member would be well advised to indicate clearly the reasons why he was unable to perform the audit in accordance with generally accepted procedures and standards.

It is not possible to exhaustively deal with instances or accepted procedure of audit applicable to special cases. Two instances of an audit requiring a special procedure are given below:

Very often members are required to certify the figures of circulation of newspapers, magazines etc. by their clients on behalf of the Audit Bureau of Circulations Ltd. Members are normally supplied by the ABC with the Rules and Regulations under which the certification of circulation is to be carried out. Members are also asked to give their acceptance in writing that they will observe the rules of procedure envisaged to report upon any lapse of such special requirements, even of an insignificant nature.

Similarly, in the case of verification on behalf of banks, the rules or procedure for conducting such audit are different from the normal rules applicable to audits under the Companies Act. Members are required to be very familiar with the special procedure required in these matters and act accordingly.

Some of the decisions of the Court on this subject are briefly summarised below:

Where a Chartered Accountant did not conduct sample checking of the bank accounts in relation to the accounts of the company and did not carry out vouching with respect to the transactions reflected in the accounts of the company and depended upon his assistant who was a Chartered Accountant and experienced clerk who were entrusted with the auditing work. Held he was guilty under Clauses (7), (8) and (9). [*M.R. Ramanathan vs A. Utnatlath Rao (1968)*]

Where a Chartered Accountant failed to verify the actual disbursement of the amount by examining the various items of purchases and insisting for the bills to be produced in respect of the various items before issuing his certificate as mere payment would not constitute utilization of the amount for the purpose for which it was meant. Held he was guilty under Clauses (7), (8) and (9). [*Punjab State Govt. vs K.N. Chandla (1972)*]

A Chartered Accountant had checked the cash book totals but not the bank column totals, had verified all the transactions in the bank columns but not the contra-entries, had taken the casting only of personal ledger and that too not of all accounts, had resorted to test check when there was no system of internal check, had not seen the pay-in-slips, had not checked the bank reconciliation statements for all the months. Held he was guilty of professional misconduct under Clauses (7), (8) and (9). [*Air Commodore Dilbagh Singh vs E.S. Venkataraman (1976)*]

Where the form of the certificate prescribed by the Audit Bureau of circulation Ltd., did not permit any alteration or explanation being given in the certificate itself, the Chartered Accountant had recorded, in a separate report the true state of affairs which he had found. Except making a report which explained the correct position he had no authority to indicate in the certificate itself the true position. But the separate report which he had sent along with the "Income Certificate" to the Newspaper concerned had not been forwarded by the newspaper to the Bureau. It was only later on that the ABC introduced a change in the procedure of audit by permitting a report being sent along with the "Income Certificate" in the various columns were subject to his separate report. Held he was guilty under Clauses (7) and (9). [*Audit Bureau of Circulations Ltd. v.s. M.L. Nanda (1968)*]

Clause (10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilize such funds only in accordance with the instructions of the client or for the purposes intended by the client. In this connection the Council has considered some practical difficulties of the members and the following suggestions have been made to remove these difficulties:

- (i) An advance received by a Chartered Accountant against services to be rendered does not fall under Clause (10) of Part I of the Second Schedule.
- (ii) Moneys received for expenses to be incurred, for example, payment of prescribed statutory fees, purchase of stamp paper etc., which are intended to be spent within a reasonably short time need not be put in a separate bank account. For this purpose, the expression; "reasonably time", would depend upon the circumstances of each case.
- (iii) Moneys received for expenses to be incurred which are not intended to be spent within a reasonably short time as aforesaid, should be put in a separate bank account immediately.
- (iv) Moneys received by a Chartered Accountant, in his capacity as trustee, executor liquidator, etc. must be put in a separate bank account immediately.

The decision of the Court in this matter is briefly mentioned below:

A Chartered Accountant was found guilty of professional misconduct under Clauses (7) & (10) of Part I of the Second Schedule to the Act for having failed to account satisfactorily for the various amounts entrusted to him by the client and for failure to keep them in a separate bank account. A refund voucher issued in the name of the client by the Income Tax Department was credited by him to his account in the bank.

22.70 Advanced Auditing and Professional Ethics

(N.S. Chenoy v.s. K.V. Subba Rao - page 958 of Vol. IV of the Disciplinary Cases and pages 207-214 of October, 1973, issue of the Institute's Journal - Judgement delivered on 6th April, 1973)

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 6(e), 19(b), 23(c) of the Practice Manual.]

PART II - Professional misconduct in relation to members of the Institute generally

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

Clause (1) contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

This clause is very important. It requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

The Regulations under which cases of contravention have generally come to the notice of the Council are the following:

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

Some of the decisions of the Court under this clause are mentioned below:

A Chartered Accountant certified in Form K-2 that an audit clerk was in service with him while he was also, employed elsewhere with another employer between 11 A.M. and 5 P.M. and attended the office of the Chartered Accountant thereafter until 8 P.M. The Chartered Accountant suspended the audit clerk when the Institute brought this fact to the notice of the Chartered Accountant. Held he was guilty of misconduct for making a misstatement to the institute in regard to the discharge of his professional duties. [*J.K. Ghosh in (1953)*]

Where a Chartered Accountant agreed to take a person as an articled clerk in a vacancy shortly to arise and received the premium for the purpose and made him believe, when he executed the deed of articles that he was taking him in that vacancy, while, in fact, that vacancy had been filled up by the Chartered Accountant earlier by taking another audit clerk. The audit clerk came to know from the Institute that the deed of articles was not registered as that was forwarded with a request for entertaining an extra articled clerk. Held that the Chartered Accountant was guilty of serious misconduct for having contravened Regulation 58. [*A.K. Basu v.s. P.K. Mukherjee (1956)*]

Where a Chartered Accountant, who was entitled to take three articled clerks, had already taken three such clerks, represented to a person that he had still a vacancy and induced him to enter into articles. A formal deed was executed and the premium was paid. He subsequently cancelled the articles of the third articled clerk for irregular attendance without reference to the Institute. Held that he had contravened the provisions of Regulation 58 and was guilty of grave misconduct. [*J.K. Ghosh (1955)*]

Where a Chartered Accountant (i) issued false certificates to two articled clerks stating that he had refunded the entire premium, while a part of it was claimed as a set off against food and halting allowances given to them while they were working in out-stations, (ii) violated Regulation 62 by not refunding the premium within the time specified in the Regulation, and (iii) the refund of premium in instalments in one case was not as specified in the certificate. Held he was guilty of dishonest behaviour both as regards his clients and articled clerks. [*M.N. Bhargava (1958)*]

Where a Chartered Accountant after signing the Articles of Agreement, failed to forward the articles for registration as required by Regulation 64 and the statement of particulars in the prescribed form as required by Regulation 64 in spite of repeated enquiries from the articled clerk and even failed to take notice of communications addressed to him in that behalf and having two other articled clerks along with the present one who articles were not sent for registration took up a fourth articled clerk without being entitled to do so. Held he was guilty for breach of Regulation 46. [*Mohan Sehwanji vs. Sunderlal Fatehpuria (1968)*]

A Chartered Accountant was found guilty of professional misconduct in terms of Clause (1) of Part II of the Second Schedule to the Act for contravention of Section 6 of the Act for having issued a certificate in respect of a consumption statement of a concern as a Chartered Accountant in practice on a date when he had not even applied for a certificate of practice to the Institute. [*N.K. Ray Chowdhery in (1973)*]

A Chartered Accountant issued a confidential and private circular to clients where, in addition to, describing himself as "Chartered Accountant" he also described himself as "Investment Consultant Public Accountant". By this circular he introduced himself to the public and private limited companies, which were accepting, fixed deposits and loans through him. Held he was guilty of professional misconduct under Clause (1) of Part II of the Second Schedule. [*B. M. Lala (1976)*]

A Chartered Accountant took loan from a firm in which the articled clerk and his father were both Interested, against the provisions of the Chartered Accountants Regulations, 1988 which prohibit 'taking of loan or deposit etc. from the articled clerk. Held the Chartered Accountant was guilty of professional misconduct under the clause. [*M.K. Tripathi (1979)*]

22.72 Advanced Auditing and Professional Ethics

A Chartered Accountant did not pay stipend to his articled clerk, in accordance with Regulation 48 of the Chartered Accountants Regulations 1988, while to another articled clerk, he was paying every month. The stipend was paid only after the articled clerk left him after working for a months and complaint was lodged with the Institute. The plea of the Chartered Accountant that he had an agreement with the articled clerk to pay stipend on annual basis was found to be misconceived as the same should be against the provisions of Regulation 48. [*Radhey Mohan (1979)*]

Three articled clerks of a Chartered Accountant informed Institute that the Chartered Accountant had failed to make the payments of stipend to them every month in accordance with Regulation 48. Held the Chartered Accountant was guilty of professional misconduct under the clause as he contravened Regulation 48 by not making the payment every month. The court rejected two contentions put forward by the Chartered Accountant, viz, (i) that the declaration filed by the articled clerks could not be regarded as 'information' in order to justify the commencement of disciplinary proceedings (2) that under Regulation 48 the payments had to be made at a monthly rate and not that the payments had to be made every month. The third contention that the payments could not be made every month or regularly because of financial stringency was also rejected particularly in view of the fact that the Chartered Accountant during the relevant period had purchased a plot of land and constructed a house at the cost of more than 1 lakh of rupees and he had in his employment throughout the relevant period a Chartered Accountant at a salary of ₹ 500 Per Month. [*R.C. Gupta (1980)*]

The Chartered Accountant received ₹ 2000/- by way of security from the complainant's father as a consideration for taking him as an articled clerk. Held that he was guilty under the provision. [*Virender Kumar v.s. K.B. Madan (1980)*]

A Chartered Accountant did not pay stipend to the articled clerk per month in accordance with Regulation 32B of the Chartered Accountant Regulations, 1964 in view of the letter written by the articled clerk to the effect that the stipend be not paid to him every month. This letter was purported to have written at the time of commencement of training- Held the letter taken from the articled clerk would not be relied upon as it was ante-dated and it was not written on the date it purported to be. The Chartered Accountant was guilty of professional misconduct under the clause. It was observed that it was very reprehensible that a practising Chartered Accountant should have tried to fabricate evidence in support of the defence. [*V.K. Mittal (1980)*]

A Chartered Accountant did not pay stipend to the articled clerk in accordance with Regulation 32B of the Chartered Accountants Regulations, 1964 for the period during which the Article Clerk worked with him. Also the Article Clerk was asked to work in excess of the prescribed working hours in violation of Regulation 45 of the Chartered Accountants Regulations, 1964. Held that he was guilty of professional misconduct under Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949. [*U.V. Benadikar vs. N.G. Kulkarni (2004)*]

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 3(b), 12(b), 12(c), 14(c), 18(c), 29(b) of the Practice Manual.]

Clause (2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.

This is an adaptation of the well-accepted principle of the law of agency. A member in the forthcoming circumstance would be guilty of misconduct regardless of the fact that he was in whole time or part-time employment or that he was carrying on practice of accountancy along with his employment. Since as employee, a member may have access to a confidential information, hence for maintaining the status and dignity of the profession in general, he should treat such information as having been provided to him only to facilitate the performance of his duties as an employee. In order to keep the confidence of the people, Chartered Accountants, should take special care not to divulge such information.

Clause (3) Includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

If a Chartered Accountant includes in any information, statement, return or form to be submitted to the Institute Council etc. any particular knowing it to be false, he will be held guilty of misconduct.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 17(d), 29(b) of the Practice Manual.]

Clause (4) Defalcates or embezzles money received in his professional capacity.

Defalcation and embezzlement of moneys received in professional capacity amounts to fraud (Covered in SA-240) and such member will be deemed to be guilty of professional misconduct under this clause.

Part III - Other misconduct in relation to members of the Institute generally

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

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

22.9 Council Guidelines

The relevant extracts of the council guidelines are given below:

Council General Guidelines, 2008.

Chapter I

Preliminary

1.0 Short title, commencement, etc.

- (a) These Guidelines have been issued by the Council of the Institute of Chartered Accountants of India under the provisions of The Chartered Accountants Act, 1949, as amended by The Chartered Accountants (Amendment) Act 2006, in supersession of the Notifications issued by the Council under erstwhile Clause (2) of Part II of the

22.74 Advanced Auditing and Professional Ethics

Second Schedule to the Chartered Accountants Act, 1949. These Guidelines be called the 'Council General Guidelines, 2008'.

- (b) These guidelines shall be applicable to all the Members of the Institute whether in practice or not wherever the context so requires.

Chapter II

Conduct of a Member being an employee

A member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

Chapter III

Appointment of a Member as Cost auditor

A member of the Institute shall not accept-

- (i) The appointment as Cost auditor of a Company under Section 233B* of the Companies Act, 1956 while he-
- (a) is an auditor of the Company appointed under Section 224 of the Companies Act; or
 - (b) is an officer or employee of the Company; or
 - (c) is a partner, of any employee or officer of the Company; or
 - (d) is a partner or is in the employment of the Company's auditor appointed under Section 224 of the Companies Act, 1956; or
 - (e) is indebted to the Company for an amount exceeding one thousand rupees, or has given any guarantee or provided any security in connection with the indebtedness of any third person to the Company for an amount exceeding one thousand rupees;

OR

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

A member of the Institute in practice shall not accept the appointment as auditor of a Company under Section 224 of the Companies Act, 1956, while he is an employee of the cost auditor of the Company appointed under Section 233B* of the Companies Act, 1956.

*** [Students may note that Section 233B of the Companies Act, 1956 on Cost Audit has been replaced with Section 148 of the Companies Act, 2013. They may refer Chapter-16 'Cost Audit' of the Study Material for detailed knowledge on cost audit.]**

Chapter IV

Opinion on financial statements when there is substantial interest

A member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons who are his "relatives" within the meaning of *Accounting Standard (AS-18) has/have, either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise.

Explanation: For this purpose and for the purpose of compliance of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, the expression “substantial interest” shall have the same meaning as is assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988.

[*In terms of its decision taken at the 299th Meeting of the Council held on 27th – 28th October, 2010, it has been decided that the term “relative” for the purpose of Chapter-IV of Council General Guidelines, 2008 (Opinion on Financial Statements when there is substantial interest) will have the same meaning as assigned to it in AS-18.]

Chapter V

Maintenance of books of account

A member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his / its professional practice, proper books of account including the following-

- (i) a Cash Book;
- (ii) a Ledger.

[Note: For illustrative examples/case studies on abovementioned clause, students may refer question no. 3(a) of the Practice Manual.]

Chapter VI

Tax Audit assignments under Section 44 AB of the Income-tax Act, 1961

A member of the Institute in practice shall not accept, in a financial year, more than the “specified number of tax audit assignments” under Section 44AB of the Income-tax Act, 1961.

Provided that in the case of a firm of Chartered Accountants in practice, the “specified number of tax audit assignments” shall be construed as the specified number of tax audit assignments for every partner of the firm.

Provided further that where any partner of the firm is also a partner of any other firm or firms of Chartered Accountants in practice, the number of tax audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the “specified number of tax audit assignments” in the aggregate.

Provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the “specified number of tax audit assignments” in the aggregate.

Provided also that the audits conducted under Section 44AD, 44AE and 44AF of the Income Tax Act, 1961 shall not be taken into account for the purpose of reckoning the “specified number of tax audit assignments”.

Explanation:

For the above purpose, “the specified number of tax audit assignments” means -

22.76 Advanced Auditing and Professional Ethics

- (a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, **60 tax audit assignments, in a financial year, whether in respect of corporate or non-corporate assesses.
- (b) in the case of firm of Chartered Accountants in practice, **60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

According to a clarification on Tax Audit Assignments by Committee on Ethical Standards Board) of the Institute, if there are 10 partners in a firm of Chartered Accountants in practice, then all the partners of the firm can collectively sign 600 tax audit reports. This maximum limit of 600 tax audit assignments may be distributed between the partners in any manner whatsoever. For instance, 1 partner can individually sign 600 tax audit reports in case remaining 9 partners are not signing any tax audit report.

In computing the “specified number of tax audit assignments” each year’s audit would be taken as a separate assignment.

In computing the “specified number of tax audit assignments”, the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

The audit of the head office and branch offices of a concern shall be regarded as one tax audit assignment.

The audit of one or more branches of the same concern by one Chartered Accountant in practice shall be construed as only one tax audit assignment.

A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the tax audit assignments of the firm.

A Chartered Accountant in practice shall maintain a record of the tax audit assignments accepted by him in each financial year in the format as may be prescribed by the Council.

** [Students may note that the specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is 60 numbers. The ceiling limit was increased from 45 to 60 numbers in February, 2014 effective for the audits conducted during the financial year 2014-15 and onwards. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.]

Chapter VII

Appointment of an Auditor in case of non-payment of undisputed fees

A member of the Institute in practice shall not accept the appointment as auditor of an entity in case the undisputed audit fee of another Chartered Accountant for carrying out the statutory

audit under the Companies Act, 1956 (now Companies Act, 2013) or various other statutes has not been paid:

Provided that in the case of sick unit, the above prohibition of acceptance shall not apply.

Explanation 1:

For this purpose, the provision for audit fee in accounts signed by both - the auditee and the auditor shall be considered as “undisputed” audit fee.

Explanation 2:

For this purpose, “sick unit” shall mean where the net worth is negative.

[Note: For illustrative examples/case studies on abovementioned council guidelines, students may refer question no. 1(b) of the Practice Manual.]

Chapter VIII

Specified number of audit assignments

A member of the Institute in practice shall not hold at any time appointment of more than the “specified number of audit assignments” of Companies under Section 224 and/or Section 228 of the Companies Act, 1956 (now Section 139 and/or Section 143(8) read with Section 141(3)(g) of the Companies Act, 2013).

Provided that in the case of a firm of Chartered Accountants in practice, the “specified number of audit assignments” shall be construed as the specific number of audit assignments for every partner of the firm.

Provided further that where any partner of the firm of Chartered Accountants in practice is also a partner of any other firm or firms of Chartered Accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the “specified number of audit assignments” in the aggregate.

Provided further where any partner of a firm or firms of Chartered Accountants in practice accepts one or more audit of Companies in his individual capacity, or in the name of his proprietary firm, the total number of such assignments which may be accepted by all firms in relation to such Chartered Accountant and by him shall not exceed the “specified number of audit assignments” in the aggregate.

Students may note that the limit for holding maximum number of assignments has been changed under the Companies Act, 2013. According to Section 141(3)(g) of the said Act, a person or a partner of a firm holding appointment as its auditor, shall not be eligible for appointment as an Auditor of a Company, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 Companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

In computing the “specified number of audit assignments”-

22.78 Advanced Auditing and Professional Ethics

- (a) the number of audit of such Companies, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.
- (b) the audit of the head office and branch offices of a Company by one Chartered Accountant or firm of such Chartered Accountants in practice shall be regarded as one audit assignment.
- (c) the audit of one or more branches of the same Company by one Chartered Accountant in practice or by firm of Chartered Accountants in practice in which he is a partner shall be construed as one audit assignment only.
- (d) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

A Chartered Accountant in practice, whether in full-time or part time employment elsewhere, shall not be counted for the purpose of determination of “specified number of audit of Companies” by firms of Chartered Accountants.

A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the audit assignments of the firm.

A Chartered Accountant in practice as well as firm of Chartered Accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of Chartered Accountants, or by any of the partners of the firm in his individual name or as a partner of any other firm, as far as possible, in the following format:

S. No.	Name of the Company	Registration Number	Date of appointment	Date of Acceptance	Date on which 23-B filed with Registrar of Companies
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[Students may note that, presently, new Form ADT-1 is required to be filed with the Registrar as per the provisions and rules made under Companies Act, 2013 in place of 23-B.]

Chapter IX

Appointment as Statutory auditor

A member of the Institute in practice shall not accept the appointment as statutory auditor of Public Sector Undertaking(s)/ Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of ₹ 50 crores or more in a year where he accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

Provided that in case appointing authority(ies)/regulatory body(ies) specify(ies) more stringent condition(s)/restriction(s), the same shall apply instead of the conditions/restrictions specified under these Guidelines.

The above restrictions shall apply in respect of fees for other work(s) or service(s) or assignment(s) payable to the statutory auditors and their associate concern(s) put together.

For the above purpose,

- (i) the term “other work(s)” or “service(s)” or “assignment(s)” shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include:-
 - (a) audit under any other statute;
 - (b) certification work required to be done by the statutory auditors; and
 - (c) any representation before an authority;
- (ii) the term “associate concern” means any corporate body or partnership firm which renders the Management Consultancy and all other professional services permitted by the Council wherein the proprietor and/or partner(s) of the statutory auditor firm and/or their “relative(s)” is/are Director/s or partner/s and/or jointly or severally hold “substantial interest” in the said corporate body or partnership;
- (iii) the terms “relative” and “substantial interest” shall have the same meaning as are assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988.

In regard to taking up other work(s) or service(s) or assignment(s) of the undertaking/company referred to above, it shall be open to such associate concern or corporate body to render such work(s) or service(s) or assignment(s) so long as aggregate remuneration for such other work(s) or service(s) or assignment(s) payable to the statutory auditor/s together with fees payable to its associate concern(s) or corporate body(ies) do/does not exceed the aggregate of fee payable for carrying out the statutory audit.

[Note: For illustrative examples/case studies on abovementioned council guidelines, students may refer question no. 18(d) of the Practice Manual.]

Chapter X

Appointment of an auditor when he is indebted to a concern

A member of the Institute in practice or a partner of a firm in practice or a firm shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹ 10,000/-

[Note: For illustrative examples/case studies on abovementioned council guidelines, students may refer question no. 21(b) of the Practice Manual.]

Chapter XI

Directions in case of unjustified removal of auditors

A member of the Institute in practice shall follow the direction given, by the Council or an appropriate Committee or on behalf of any of them, to him being the incoming auditor(s) not to accept the appointment as auditor(s), in the case of unjustified removal of the earlier auditor(s).

22.10 Recommended Self-Regulatory Measures

As the members are aware, the Council has decided upon certain self-regulatory measures in order to ensure a healthy growth of the profession and an equitable flow of professional work among the members. These measures are reviewed from time to time and are published in the Journal of the Institute for observance by the members. The self-regulatory measures are recommendatory. However, considering the spirit underlying these measures, the Council expects that each and every member will effectively implement them. The Council earnestly believes that implementation of these measures would go a long way in ensuring equitable flow of work among the members and would also further enhance the prestige of the profession in the society.

The more important of these recommendations are as under:

22.10.1 Branch Audits - The branch audits of a company should not be conducted by its statutory auditors consisting of ten or more members, but should be conducted by the local firms of auditors consisting of less than ten members. This should not be understood to mean any restriction on the right of the statutory auditors to have access over branch accounts conferred under the Companies Act, 1956 (now Companies Act, 2013). This restriction may not apply in the following cases.

- (i) where the accounting records of the branches are maintained at the head office of the respective companies, and
- (ii) where significant operations of an undertaking or a company are carried out at its branch office.

22.10.2 Joint Audit - In the case of large companies the practice of associating a practicing firm with less than five members as Joint auditors should be encouraged. Where a client desires to appoint such a firm as joint auditor, the senior firm should not object to the same.

22.10.3 Ratio Between Qualified and Unqualified Staff: In the Council's view, a practicing firm of Chartered Accountants engaged in audit work should have at least one member for every five non-qualified members of the staff, excluding articled and audit clerks, typists, peons and other persons not engaged directly in such professional work.

22.10.4 Disclosure of Interest by Auditors in other Firms - The Council has decided that as a good and healthy practice, auditors should make a disclosure of the payments received by them for other services through the medium of a different firm or firms in which the said auditor may be either a partner or proprietor.

[Important Note: Students may note that, in view of the fact that with effect from 01.04.2014, the Companies Act, 1956 has been replaced with Companies Act, 2013, the "Code of Ethics" issued by ICAI is under revision. Till the time the "Code of Ethics" gets amended in accordance with Companies Act, 2013, students may quote revised provisions along with the old provisions.]

Annexure – 1

The Chartered Accountants Act, 1949

The Chartered Accountants Act, 1949 (No. 38 of 1949) came into force on the 1st day of July, 1949. Later in the year 1959, certain amendments were made therein through the Chartered Accountants (Amendment) Act, 1959 (No.15 of 1959). After about 47 years extensive changes have been made in the Act through the Chartered Accountants (Amendment) Act, 2006 (No.9 of 2006) which have been notified by the Central Government in the Gazette of India (Extra Ordinary) dated 23rd March, 2006. Further, few insertions were made to the principle Act through the Chartered Accountants (Amendment) Act, 2011 (No. 3 of 2012).

The entire Act is divided in nine chapters [Including chapter VIIA inserted by Chartered Accountants (Amendment) Act, 2006].

The Complete enumeration of Contents is given below:

Chapter I - Preliminary

1. Short title, Extent and Commencement
2. Interpretation

This Chapter contains preliminary aspects of the Act like applicability of the Act, definition of various terms like, Chartered Accountant, Council, holder of a restricted certificate, Registered Accountant, etc.

Chapter II - The Institute of Chartered Accountants of India

3. Incorporation of the Institute
4. Entry of names in the Register
5. Fellows and Associates
6. Certificate of Practice
7. Members to be known as Chartered Accountants
8. Disabilities

This chapter deals with various things like who shall be entitled to have his name entered in the register of members of the Institute, who shall be deemed to have become an associate member of the Institute, who shall be entered in the Register as a fellow of the Institute. This Chapter also deals with issues relating to certificate of practice and disabilities of a person for having his name entered in the Register.

Chapter III - Council of the Institute

9. Constitution of the Council of the Institute
10. Re-election or re-nomination to Council [Substituted by Chartered Accountants (Amendment) Act, 2006]
- 10A. Settlement of dispute regarding election [Inserted by Chartered Accountants (Amendment) Act, 2006]

22.82 Advanced Auditing and Professional Ethics

- 10B. Establishment of Tribunal [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 11. Nomination in default of election or nomination
- 12. President and Vice-President
- 13. Resignation of Membership and casual vacancies
- 14. Duration and dissolution of the Council
- 15. Function of the Council
- 15A. Imparting education by Universities and Other bodies [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 16. Officers and employees, salary, allowances etc. [substituted by Chartered Accountants (Amendment) Act, 2006]
- 17. Committees of the Council
- 18. Finances of the Council

This Chapter deals with various issues like composition of Council of the Institute, manner of conducting election to the Council, mode of tendering resignation from the membership of the Council mode of filling a casual vacancy, various duties of the Council. This Chapter also deals with the permission accorded to any University established by law or any Body affiliated to the Institute to impart education on the subjects covered by the academic courses of the Institute.

Chapter IV - Register of Members

- 19. Register of Members
- 20. Removal from the Register

This chapter deals with the matters relating to register of members and removal from the register the name of any member. The Council has to maintain a Register of Members of the Institute. This Register shall include name, date of birth, domicile, residential and professional address, qualification etc. Also, the Council may remove from the Register the name of any member in certain circumstances like in case of death of the member or if the member does not pay the prescribed fees, or when a member has become subject to any of the disabilities mentioned in section 8.

Chapter V - Misconduct

- 21. Disciplinary Directorate [Substituted by Chartered Accountants (Amendment) Act, 2006]
- 21A. Board of Discipline [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 21B. Disciplinary Committee [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 21C. Authority, Disciplinary Committee, Board of Discipline and Director (Discipline) to have powers of civil court [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 21D. Transitional provisions [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 22. Professional or other misconduct defined [Substituted by Chartered Accountants (Amendment) Act, 2006]

- 22A. Constitution of Appellate Authority [Substituted by Chartered Accountants (Amendment) Act, 2006]
- 22B. Term of office of Chairperson and members of Authority [Inserted by Chartered Accountants (Amendment) Act, 2006].
- 22C. Allowances and conditions of service of Chairperson and Members of Authority (Inserted by Chartered Accountants (Amendment) Act, 2006)
- 22D. Procedure to be regulated by Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 22E. Officers and other staff of Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 22F. Resignation and removal of Chairperson and Members [Inserted by Chartered Accountants (Amendment) Act, 2006]
- 22G. Appeal to Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

In this chapter professional and other misconduct has been defined. As per section 22 of the Act, the expression "professional or other misconduct " shall be deemed to include any act or omission provided in any of the Schedules. In this chapter, Section 21, 22 and 22A have been substituted by new sections 21, 22 and 22A. Other sections (Section 21A, 21B, 21C, 21D, 22B, 22C, 22D, 22E, 22F and 22G) have been inserted by Chartered Accountants (Amendment) Act, 2006. These Sections along with the Schedules deal with the new Disciplinary Mechanism.

Chapter VI - Regional Councils

23. Constitution and Functions of Regional Councils

The Councils may constitute such Regional Councils for the purpose of advising and assisting it on matters concerning its functions. The Regional councils shall exercise prescribed functions.

Chapter VII - Penalties

- 24. Penalty for falsely claiming to be a member etc.
- 24A. Penalty for using name of the Council, awarding degree of Chartered Accountancy etc.
- 25. Companies not to engage in accountancy
- 26. Unqualified persons not to sign documents
- 27. Maintenance of branch offices
- 28. Sanction to prosecute

This chapter lists penalties in various cases like, if a person who is not a member of the Institute and represents himself as a member of the Institute or uses the designation Chartered Accountant, he shall be punishable with fine which may extend to one thousand rupees (on first conviction) and with imprisonment which may extend to six months or with fine which may extend to five thousand rupees or with both (on subsequent conviction). Other provisions regarding penalties that are included in this chapter provide that a Company (Incorporated in or outside India) shall not practice as Chartered Accountant, a person other than a member of the Institute

22.84 Advanced Auditing and Professional Ethics

shall not sign any document on behalf of a Chartered Accountant in practice or a firm of such Chartered Accountants in his or its professional capacity, etc.

Chapter VII A Quality Review Board

[Inserted by Chartered Accountants (Amendment) Act, 2006]

28A. Establishment of Quality Review Board

28B. Functions of Board

28C. Procedure of Board

28D. Terms and conditions of services of Chairperson and Members of Board and its expenditure

After Chapter VII, the Chapter VIIA has been inserted by the Chartered Accountants (Amendment) Act, 2006. It empowers the Central Government to constitute a Quality Review Board outside the framework of the Institute. It will perform the functions like, to make recommendations to the Council with regard to the quality of services provided by the members of the Institute, to review the quality of services provided by the members of the Institute including audit services and to guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements.

Chapter VIII – Miscellaneous

29. Reciprocity

29A. Power of Central Government to make rules.

30. Power to make regulations

30A. Powers of the Central Government to direct regulation to be made or to make or amend regulations

30B. Rules, Regulations and notification to be laid before Parliament [Substituted by Chartered Accountants (Amendment) Act, 2006]

30C. Power of Central Government to issue directions [Inserted by Chartered Accountants (Amendment) Act, 2006]

30D. Protection of action taken in good faith [Inserted by Chartered Accountants (Amendment) Act, 2006]

30E. Members etc. to be public servants [Inserted by Chartered Accountants (Amendment) Act, 2006]

31. Construction of References

32. Act not to affect right of accountants to practice as such in Acceding States.

33. [Repealed]

This Chapter contains miscellaneous provisions. It empowers the Council to prescribe the conditions subject to which foreign qualifications relating to accountancy shall be recognized for the purpose of entry in the Register. It also empowers the Council to make regulations for the purpose of carrying out the objects of this Act. It also empowers the Central Government to direct the Council to make any regulations or to amend or revoke any regulations already made.

Section 30C, 30D, and 30E have been inserted by Chartered Accountants (Amendment) Act, 2006. Section 30C empowers the Central Government to issue directions in the event of non-compliance by the Council of any provisions of the Act. Section 30D protects Central Government, Council, Authority Disciplinary Committee, Tribunal, Board, Board of Discipline, Disciplinary Directorate or any officer thereof, for anything which is in good faith done or intended to be done under this Act or any rule, regulation, notification, direction or order made there under. Section 30E says that the Chairperson, Presiding officer, Members and other officers and employees of the Authority, Disciplinary Committee, Tribunal, Board, Board of Discipline or the Disciplinary Directorate shall be deemed to be public servants within the meaning of Section 21 of the Indian Penal Code.

Annexure – 2

Relevant sections of the Chartered Accountants Act, 1949 with respect to disciplinary procedure are provided below:

Section 21. Disciplinary Directorate –

- (1) The Council shall, by notification, establish a Disciplinary Directorate headed by an officer of the Institute designated as Director (Discipline) and such other employees for making investigations in respect of any information or complaint received by it.
- (2) On receipt of any information or complaint along with the prescribed fee, the Director (Discipline) shall arrive at a prima facie opinion on the occurrence of the alleged misconduct.
- (3) Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the First Schedule, he shall place the matter before the Board of Discipline and where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the Second Schedule or in both the Schedules, he shall place the matter before the Disciplinary Committee.
- (4) In order to make investigations under the provisions of this Act, the Disciplinary Directorate shall follow such procedure as may be specified.
- (5) Where a complainant withdraws the complaint, the Director (Discipline) shall place such withdrawal before the Board of Discipline or, as the case may be, the Disciplinary Committee, and the said Board or Committee may, if it is of the view that the circumstances so warrant, permit the withdrawal at any stage.

Section 21A. Board of Discipline –

- (1) The Council shall constitute a Board of Discipline consisting of -
 - (a) a person with experience in law and having knowledge of disciplinary matters and the profession, to be its presiding officer;
 - (b) two members one of whom shall be a member of the Council elected by the Council and the other member shall be nominated by the Central Government from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy;

22.86 Advanced Auditing and Professional Ethics

- (c) the Director (Discipline) shall function as the Secretary of the Board.
- (2) The Board of Discipline shall follow summary disposal procedure in dealing with all cases before it.
- (3) Where the Board of Discipline is of the opinion that a member is guilty of a professional or other misconduct mentioned in the First Schedule, it shall afford to the member an opportunity of being heard before making any order against him and may thereafter take any one or more of the following actions, namely:
 - (a) reprimand the member;
 - (b) remove the name of the member from the Register up to a period of three months;
 - (c) impose such fine as it may think fit, which may extend to rupees one lakh.
- (4) The Director (Discipline) shall submit before the Board of Discipline all information and complaints where he is of the opinion that there is no prima facie case and the Board of Discipline may, if it agrees with the opinion of the Director (Discipline), close the matter or in case of disagreement, may advise the Director (Discipline) to further investigate the matter.

Section 21B. Disciplinary Committee –

- (1) The Council shall constitute a Disciplinary Committee consisting of the President or the Vice-President of the Council as the Presiding Officer and two members to be elected from amongst the members of the Council and two members to be nominated by the Central Government from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy.

Provided that the Council may constitute more Disciplinary Committees as and when it considers necessary.

- (2) The Disciplinary Committee, while considering the cases placed before it shall follow such procedure as may be specified.
- (3) Where the Disciplinary Committee is of the opinion that a member is guilty of a professional or other misconduct mentioned in the Second Schedule or both the First Schedule and the Second Schedule, it shall afford to the member an opportunity of being heard before making any order against him and may thereafter take any one or more of the following actions, namely:
 - (a) reprimand the member;
 - (b) remove the name of the member from the Register permanently or for such period, as it thinks fit;
 - (c) impose such fine as it may think fit, which may extend to rupees five lakh.
- (4) The allowances payable to the members nominated by the Central Government shall be such as may be specified.

Section 21C. Authority, Disciplinary Committee, Board of Discipline and Director (Discipline) to have powers of civil court – For the purposes of an inquiry under the provisions of this Act, the Authority, the Disciplinary Committee, Board of Discipline and the Director

(Discipline) shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), in respect of the following matters, namely:

- (a) summoning and enforcing the attendance of any person and examining him on oath;
- (b) the discovery and production of any document; and
- (c) receiving evidence on affidavit.

Explanation: for the purposes of sections 21, 21A, 21B, 21C and 22, “member of the Institute” includes a person who was a member of the Institute on the date of the alleged misconduct although he has ceased to be a member of the Institute at the time of the inquiry.

Section 21D. Transitional provisions – All complaints pending before the Council or any inquiry initiated by the Disciplinary Committee or any reference or appeal made to a High Court prior to the commencement of the Chartered Accountants (Amendment) Act, 2006, shall continue to be governed by the provisions of this Act, as if this Act had not been amended by the Chartered Accountants (Amendment) Act, 2006.

Section 22. Professional or other misconduct defined – For the purposes of this Act, the expression “professional or other misconduct” shall be deemed to include any act or omission provided in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of section 21 to inquire into the conduct of any member of the Institute under any other circumstances.

Section 22A. Constitution of Appellate Authority –

- (1) The Central Government shall, by notification, constitute an Appellate Authority consisting of -
 - (a) a person who is or has been a judge of a High Court, to be its Chairperson;
 - (b) two members to be appointed from amongst the persons who have been members of the Council for at least one full term and who are not sitting members of the Council;
 - (c) two members to be nominated by the Central Government from amongst persons having knowledge and practical experience in the field of law, economics, business, finance or accountancy.
- (2) The Chairperson and other members shall be part-time members.

Section 22B. Term of office of Chairperson and members of Authority –

- (1) A person appointed the Chairperson shall hold office for a term of three years from the date on which he enters upon his office or until he attains the age of sixty-five years, whichever is earlier.
- (2) A person appointed as a member shall hold office for a term of three years from the date on which he enters upon his office or until he attains the age of sixty-two years, whichever is earlier.

Section 22C. Allowances and conditions of service of Chairperson and members of Authority – The allowances payable to, and other terms and conditions of service of, the

22.88 Advanced Auditing and Professional Ethics

Chairperson and members and the manner of meeting expenditure of the Authority by the Council and such other authorities shall be such as may be specified.

Section 22D. Procedure to be regulated by Authority –

- (1) The office of the Authority shall be at Delhi.
- (2) The Authority shall regulate its own procedure.
- (3) All orders and decisions of the Authority shall be authenticated by an officer duly authorised by the Chairperson in this behalf.

Section 22E. Officers and other staff of Authority –

- (1) The Council shall make available to the Authority such officers and other staff members as may be necessary for the efficient performance of the functions of the Authority.
- (2) The salaries and allowances and conditions of service of the officers and other staff members of the Authority shall be such as may be prescribed.

Section 22F. Resignation and removal of Chairperson and members –

- (1) The Chairperson or a member may, by notice in writing under his hand addressed to the Central Government, resign his office.

Provided that the Chairperson or a member shall, unless he is permitted by the Central Government to relinquish his office sooner, continue to hold office until the expiry of three months from the date of receipt of such notice or until a person duly appointed as his successor enters upon his office or until the expiry of term of office, whichever is earlier.

- (2) The Chairperson or a member shall not be removed from his office except by an order of the Central Government on the ground of proved misbehaviour or incapacity after an inquiry made by such person as the Central Government may appoint for this purpose in which the Chairperson or a member concerned has been informed of the charges against him and given a reasonable opportunity of being heard in respect of such charges.

Section 22G. Appeal to Authority –

- (1) Any member of the Institute aggrieved by any order of the Board of Discipline or the Disciplinary Committee imposing on him any of the penalties referred to in sub-section (3) of section 21A and sub-section (3) of section 21B, may within ninety days of the date on which the order is communicated to him, prefer an appeal to the Authority.

Provided that the Director (Discipline) may also appeal against the decision of the Board of Discipline or the Disciplinary Committee to the Authority, if so authorised by the Council, within ninety days.

Provided further that the Authority may entertain any such appeal after the expiry of the said period of ninety days, if it is satisfied that there was sufficient cause for not filing the appeal in time.

- (2) The Authority may, after calling for the records of any case, revise any order made by the Board of Discipline or the Disciplinary Committee under sub-section (3) of section 21A and sub-section (3) of section 21B and may -
- (a) confirm, modify or set aside the order;
 - (b) impose any penalty or set aside, reduce, or enhance the penalty imposed by the order;
 - (c) remit the case to the Board of Discipline or Disciplinary Committee for such further enquiry as the Authority considers proper in the circumstances of the case; or
 - (d) pass such other order as the Authority thinks fit:

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

FINAL COURSE STUDY MATERIAL

AUDITING PRONOUNCEMENTS



**BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

The objective of this material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, this material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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A WORD ABOUT AUDITING PRONOUNCEMENTS

The audit of financial statements add credibility to financial statements prepared by the management of the entity and ensure that the financial statements are prepared in accordance with the legal and regulatory requirements applicable to the entity and are free from any material misstatement.

For ensuring quality in audits, it is essential to have auditing standards for auditors which are at par with globally accepted auditing standards. The Engagement and Quality Control Standards developed by the Auditing and Assurance Standards Board of the ICAI and issued under the authority of the Council of the ICAI are harmonized with the globally recognized International Standards issued by the International Auditing and Assurance Standards Board (IAASB).

In respect of audit engagements, these Standards cover the important aspects such as planning, documentation, risk assessment, fraud considerations, evidence, reporting, etc. Separate Standards deal with other assurance engagements, review engagements and related services. These Standards are principle based and mandatory in nature.

Similarly, Statements on certain important aspects of an audit of a company have been issued for the benefit of the auditors. These Statements, too, are mandatory in nature.

On many occasions, guidance is required on certain procedural aspects of audits of financial statements, which may not, per se, specifically be dealt with by the Standards or they might need additional guidance on carrying out assurance engagements in terms of requirements of some specific laws or regulations. These Guidance Notes are recommendatory in nature.

Keeping all this in view, it has been decided to publish a separate book namely Auditing Pronouncements for the students. This book is quite handy and will be highly useful for the students since they will get all the relevant auditing pronouncements at one place for easy reference.

This handbook has been divided into three parts for the convenience of the students.

- First part contains the Authority and Preface, Glossary of Terms, Standards on Quality Control, Framework for Assurance engagements alongwith SAs, SREs, SAEs and SRSs.
- Second part comprises the Statement of Reporting under section 227 (1A) of the Companies Act, 1956.
- Third part of the book carries the applicable Guidance Notes prescribed at CA Final Level which is given in CD.

It is pertinent to note that necessary references have also been given in line with the Companies Act, 2013 at the appropriate places in this book for better understanding of students.

Happy Reading and Best Wishes!

CONTENTS

AUDITING PRONOUNCEMENT

Announcements of the Council Regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India.....	1
---	---

PART I : AUDITING AND ASSURANCE STANDARDS

Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.....	1.1
---	------------

Glossary of Terms	1.11
--------------------------------	-------------

Standard on Quality Control (SQC) 1	1.31
--	-------------

Framework for Assurance Engagements	1.51
--	-------------

Standards on Auditing (SAs)

SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	1.67
---	------

SA 210 Agreeing the Terms of Audit Engagements	1.87
--	------

SA 220 Quality Control for an Audit of Financial Statements	1.103
---	-------

SA 230 Audit Documentation	1.115
----------------------------------	-------

SA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	1.123
---	-------

SA 250 Consideration of Laws and Regulations in an Audit of Financial Statements ...	1.154
--	-------

SA 260(Revised) Communication with Those Charged with Governance.....	1.164
---	-------

SA 265 Communicating Deficiencies in Internal Control to Those Charged With Governance and Management	1.182
---	-------

SA 299 Responsibility of Joint Auditors	1.190
---	-------

SA 300 Planning an Audit of Financial Statements	1.193
--	-------

SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	1.201
--	-------

SA 320 Materiality in Planning and Performing an Audit	1.237
--	-------

SA 330 The Auditor's Responses to Assessed Risks	I.243
SA 402 Audit Considerations Relating to an Entity Using a Service Organisation.....	I.259
SA 450 Evaluation of Misstatements identified During the Audit	I.275
SA 500 Audit Evidence	I.283
SA 501 Audit Evidence - Specific Considerations for Selected Items	I.295
SA 505 External Confirmations	I.302
SA 510 Initial Audit Engagements – Opening Balances	I.310
SA 520 Analytical Procedures.....	I.319
SA 530 Audit Sampling	I.325
SA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures	I.335
SA 550 Related Parties	I.366
SA 560 Subsequent Events	I.385
SA 570 (Revised)Going Concern	I.393
SA 580 Written Representations	I.411
SA 600 Using the Work of Another Auditor	I.421
SA 610 (Revised) Using the Work of Internal Auditors.....	I.425
SA 620 Using the Work of an Auditor's Expert.....	I.446
SA 700 (Revised) Forming an Opinion and Reporting on Financial Statements	I.459
SA 701(New) Communicating Key Audit Matters in the Independent Auditor's Report .	I.501
SA 705((Revised) Modifications to the Opinion in the Independent Auditor's Report ...	I.517
SA 706 (Revised) Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.....	I.538
SA 710 Comparative Information – Corresponding Figures and Comparative Financial Statements	I.549
SA 720 The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	I.562

SA 800 Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	I.566
SA 805 Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement.....	I.575
SA 810 Engagements to Report on Summary Financial Statements.....	I.587

Standards on Review Engagements (SREs)

SRE 2400 (Revised) Engagements to Review Historical Financial Statements.....	I.603
SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity	I.660

Standards on Assurance Engagements (SAEs)

SAE 3400 The Examination of Prospective Financial Information	I.688
SAE 3402 Assurance Reports On Controls At A Service Organisation	I.699
SAE 3420 (New) Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus	I.732

Standards on Related Services (SRSs)

SRS 4400 Engagements to Perform Agreed Upon Procedures Regarding Financial Information	I.755
SRS 4410 (Revised) Compilation Engagements	I.762

PART II : STATEMENTS

Statements on Reporting under section 227(1A) of the Companies Act, 1956	II.1
--	------

PART III : GUIDANCE NOTES (Given in CD)

Announcements of the Council Regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India

A. Clarification regarding Authority Attached to Documents Issued by the Institute¹

1. The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. With the formation of the Accounting Standards Board and the Auditing Practices Committee², 'Accounting Standards' and 'Statements on Standard Auditing Practices'³ are also being issued.

2. Members have sought guidance regarding the level of authority attached to the various documents issued by the Institute and the degree of compliance required in respect thereof. This note is being issued to provide this guidance.

3. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and
- (b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.

¹ Published in the December, 1985 issue of the 'The Chartered Accountant'.

² The Auditing Practices Committee of the Institute of Chartered Accountants of India was established in 1982 with, *inter alia*, the objectives of preparing the Statements on Standard Auditing Practices (SAPs), Guidance Notes on matters related to auditing, etc. At its 226th meeting held on July 2, 2002 at New Delhi, the Council of the Institute of Chartered Accountants of India approved the recommendations of the Auditing Practices Committee to strengthen the role being played by it in the growth and development of the profession of chartered accountancy in India. The Council also approved renaming of the Committee as, "Auditing and Assurance Standards Board" (AASB) with immediate effect to better reflect the activities being undertaken by the Committee. Apart from changes designed to strengthen the process for establishing auditing and assurance standards, such a move would bring about greater transparency in the working of the Auditing Practices Committee now known as the Auditing and Assurance Standards Board (AASB).

The Council also approved the renaming of the Statements on Standard Auditing Practices (SAPs) as, "Auditing and Assurance Standards" (AASs). The ICAI in 2007 issued the 'Revised Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services'. Pursuant to issuance of Revised Preface, the Auditing and Assurance Standards (AAS) have been renamed as 'Engagement and Quality Control Standards'. The Engagement Standards comprise:

- *Standards on Auditing (SAs)* - To be applied in the audit of historical financial information.
- *Standards on Review Engagements (SREs)* - To be applied in the review of historical financial information.
- *Standards on Assurance Engagements (SAEs)* - To be applied in assurance engagements, other than audits and reviews of historical financial information.
- *Standards on Related Services (SRSs)* - To be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

³ *ibid.*

2 Auditing Pronouncements

4. A list of 'Statements' issued by the Institute and currently in force is given at the end of this note.⁴
5. 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.
6. There are however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function. A list of these guidance notes is given below:
 - (i) Guidance Note on Treatment of Interest on Deferred Payments read along with the pronouncement of the Council, published in 'The Chartered Accountant', March 1984.⁵
 - (ii) Provision for Depreciation in respect of Extra or Multiple Shift Allowance, published in 'The Chartered Accountant', May 1984.⁶
7. The 'Accounting Standards' and 'Statements on Standard Auditing Practices'⁷ issued by the Accounting Standards Board and the Auditing Practices Committee⁸, respectively, establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards and that auditors carry out their audits in accordance with the generally accepted auditing practices. They become mandatory on the dates specified either in the respective document or by notification issued by the Council.⁹
8. There can be situations in which certain matters are covered both by a 'Statement' and by an

⁴ An updated list of mandatory statements on auditing is included in the 'List of Mandatory Statements and Standards' given after this clarification. It may also be noted that besides statements on accounting and auditing, the Institute has issued statements on other aspects also, namely, Statement on Peer Review and Statement on Continuing Professional Education.

⁵ The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Treatment of Interest on Deferred Payments'. In view of para 8 of this 'Clarification', with Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', becoming mandatory (see Announcement II) in respect of accounts for periods commencing on or after 1.4.1991, the 'Statement on Treatment of Interest on Deferred Payments' stands automatically withdrawn except in the case of certain specified non-corporate entities where it stands withdrawn in respect of accounts for periods commencing on or after 1.4.1993 (see Announcements III, V and VI in this regard). It may be noted that pursuant to the issuance of Accounting Standard (AS) 16 on 'Borrowing Costs', which came into effect in respect of accounting periods commencing on or after 1-4-2000, paragraph 9.2 and paragraph 20 (except the first sentence) of AS 10, relating to treatment of finance costs including interest, stand withdrawn from that date.

⁶ The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Provision for Depreciation in respect of Extra or Multiple Shift Allowance'. This statement has been withdrawn in respect of accounting periods commencing on or after 1.4.1989, as per the Guidance Note on Accounting for Depreciation in Companies, issued in pursuance of amendments in the Companies Act, 1956, through Companies (Amendment) Act, 1988.

⁷ Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards'.

⁸ Refer footnote 2. The 'Auditing Practices Committee' has been renamed as 'Auditing and Assurance Standards Board'.

⁹ Subsequent to the publication of this Clarification, the Council has made various Accounting Standards mandatory. The Announcements made by the Council in this regard are reproduced hereafter.

'Accounting Standard'/Statement on Standard Auditing Practices'¹⁰. In such a situation, the 'Statement' shall prevail till the time the relevant 'Accounting Standard'/Statement on Standard Auditing Practices'¹¹ becomes mandatory. It is clarified that once an 'Accounting Standard'/Statement on Standard Auditing Practices'¹² becomes mandatory, the concerned 'Statement' or the relevant part thereof shall automatically stand withdrawn.

9. List of statements issued by the Institute and which are mandatory in nature.

1. Statement on Companies (Auditor's Report) Order, 2003 (Revised 2005)
2. Statement on Reporting under Section 227(1A) of the Companies Act, 1956.

B. Use of Bold Type Face/ Normal Type Face in Auditing and Assurance Standards

- I. As the members are aware, the Institute of Chartered Accountants of India has till date issued 35 (thirty five) Auditing and Assurance Standards (AASs). It may be reiterated that all the Standards are mandatory in nature. This means that while carrying out an attest function, it will be the duty of the members of the Institute to ensure that these AASs are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the AASs, his report should draw attention to the material departures therefrom.
- II. Further, it might have been noted by the members that in case of AAS 1 to AAS 15, the entire text of the Standards appears in normal type face, except for the headings and sub headings therein. On the other hand, in case of AAS 16 to AAS 35, certain text in the Standards is appearing in **bold type** face and certain portion of the text appearing in normal type face. Normally, in these Standards, the **bold type** face has been used to facilitate distinction between the principles *vis-a-vis* the application/ procedural aspects, which have been written in normal type face. In any case, however, the entire text of the Standard is mandatory, irrespective of the fact whether such distinction is made in the Standard or not.

The New Format (applicable from 1st April, 2008)¹³

- III. Members may also note that recently, the Council of the Institute of Chartered Accountants of India has approved the **Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services**. The said Preface introduces a totally new format of writing Standards, in line with that adopted by the International Auditing and Assurance Standards Board pursuant to its Clarity Project. According to the new format the Standards on Auditing (SAs) would now contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.
- IV. The fundamental principles of the Standard are contained in the Requirements section and represented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format also does away with the need to present the principles laid down by the Standard in bold text. The application and other explanatory material contained in a Standard on Auditing (SA) is an integral part of the SA as it provides further explanation of, and

¹⁰ Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards'.

¹¹ *ibid.*

¹² *ibid.*

¹³ The "Preface to Standards on Quality control, auditing, Review, Other Assurance and Related Services" and the document containing the reclassification and renumbering of the Auditing and Assurance Standards issued by the Institute have been published in July 2007 issue of the Journal.

4 Auditing Pronouncements

guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement. In view of this format of writing, the **standard portion or principles enunciated in a Standard would no longer be given in bold face.**

- V. The new presentation format has, however, not as yet been followed in drafting the Standards on Quality Control and other Standards.
- VI. **There is no change in the authority attached to the Standards, i.e., they are mandatory in nature, notwithstanding the new format of writing the Standards.**

C. Announcements/ Clarifications

1. *Clarification on the Auditors' Rights Where Clients and Other Auditors Seek Access to their Audit Working Papers**

- I. Auditing and Assurance Standard (AAS) 1¹⁴, "Basic Principles Governing An Audit", states in para 6, "The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". Auditing and Assurance Standard (AAS) 3¹⁵, "Documentation" (Paragraph 13), states, "Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client." AAS 3 further requires (paragraph 14), *inter alia*, that the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers."
- II. Part I of the Second Schedule to the Chartered Accountants Act, 1949 provides that "A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he –
"Discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."
- III. Requests are sometimes received by the members of the Institute, who have/had been performing the duties as the auditors of an enterprise, to provide access to their audit working papers. The requests may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.
- IV. It is hereby clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor¹⁶. For this purpose, the term 'auditor' includes 'internal auditor'.
- V. As stated in para 4, the client does not have a right to access the working papers of the auditor.

* Published in May, 2000 issue of 'The Chartered Accountant'.

¹⁴ Now known as Standard on Auditing (SA) 200.

¹⁵ Now known as Standard on Auditing (SA) 230.

¹⁶ Reference in this regard may be made to Standard on Auditing (SA) 600, "Using the Work of Another Auditor" and Standard on Auditing (SA) 610, "Relying on the Work of Internal Auditor."

However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client.

2. Format of Review Report under Clause 41 of the Listing Agreement**

- I. As the members are aware, the Institute had in March 2005, issued Auditing and Assurance Standard (AAS) 33¹⁷, Engagements to Review Financial Statements, applicable to all review engagements relating to accounting periods beginning on or after April 1, 2005. Appendix 3 to the said AAS contains an illustrative format of review report in respect of balance sheet. The illustrative format given in the AAS is different from the format of the review report required to be given under clause 41 of the Listing Agreement in that it is in respect of review of financial results and not a balance sheet.
- II. In view of the above, the members are requested to note that in so far as review carried out in terms of clause 41 of the Listing Agreement is concerned, the members are expected to submit their review report in accordance with the format prescribed by the Securities and Exchange Board of India in clause 41 of the Listing Agreement.

3. Audit in Situations of Missing or Incomplete Records***

- I. Members of the Institute while carrying out audit assignments might come across a situation where the records of the client are incomplete or destroyed (partially or completely) on account of a natural calamity or otherwise. While guidance on reporting responsibilities of the members in such cases has been provided to the members by way of publications such as Auditing and Assurance Standard (AAS) 28¹⁸, The Auditor's Report on Financial Statements", the Statement on Qualifications in Auditor's Report, opinions of the Expert Advisory Committee, and a publication titled, "Study on Audit and Certification in Case of Missing Records", issued by the Institute, the Council, for the benefit of the members, wishes to reiterate the guidance in the following paragraphs.
- II. The auditor should, first, obtain a representation from the management that the original accounts are not available for audit. The letter should also include the fact whether the accounts of the entity have been reconstructed by the management. If yes, the extent thereof (partial or complete) and the details of the items of financial statements that have been reconstructed should also be specified in the said letter. In case the accounts have been reconstructed, the members must consider the limitation of scope in audit imposed by the circumstances. Limitation on scope of audit can be of two types, firstly, inability of the management to reconstruct some or all of the items of the financial statements either for the whole financial year or for a certain period during the financial year and secondly, lack of corroborative evidence to support certain or all the entries in the reconstructed accounts. In case of completely reconstructed accounts, the lack of supporting evidence will pose a greater risk of limitation on scope, whereas, for partially reconstructed accounts, both types of limitations, i.e., inability of the management to reconstruct accounts and lack of supporting evidence, can be material. While auditing the reconstructed accounts (partial as well as complete), the auditor should analyse the limitation imposed on application of audit procedures required to be applied in the given situation and use his professional judgment to determine whether to issue an unqualified opinion, qualified opinion or disclaimer of

** Issued in July, 2005.

¹⁷ Now known as Standard on Review Engagements (SRE) 2400.

*** Issued in October, 2006.

¹⁸ Now known as Standard on Auditing (SA) 700.

opinion. Further, the fact of scope limitation must clearly be mentioned in the scope paragraph of the audit report. The AAS 28, "The Auditor's Report on Financial Statements", in its paragraphs 43 and 44 reproduced below, provides the guidance for the auditor in case of a scope limitation:

"43. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, **the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.** (emphasis added)

44. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed."

- III. Guidance in respect of the matter discussed in the two paragraphs above has been explained in paragraph 45 of the AAS 28 by way of illustrative examples of the scope paragraphs in the audit reports in the cases of qualified opinion and disclaimer of opinion:

In situations of Qualified Opinion

"We have audited

Except as discussed in the following paragraph, we conducted our audit in accordance with

We did not observe the counting of the physical inventories as at 31st March 2XXX since that date was prior to the time we were appointed as auditors of(Name of the entity). Owing to the nature of the entity's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures."

In situations of Disclaimer of Opinion

"The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances. (emphasis added)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the entity."

- IV. Paragraph 10 of AAS 13¹⁹, "Audit Materiality", reproduced below, states that the auditor while auditing the reconstructed accounts must consider the concept of materiality and the audit risk involved with specific account balances and classes of transactions:

"10. *There is an inverse relationship between materiality and the degree of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. The auditor takes the inverse relationship between materiality and audit risk into account when determining*

¹⁹ Now known as Standard on Auditing (SA) 320.

the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:

- (a) reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or*
- (b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.”*

- V. While auditing the reconstructed accounts, since the auditor would normally find it difficult to obtain internally generated corroborative evidences supporting the reconstructed accounts, the auditor should apply alternative audit procedures such as inquiry and external confirmation as outlined in paragraphs 14 and 15 of the AAS 5²⁰, “Audit Evidence”, reproduced below:

“Inquiry and Confirmation

- 14. *Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.*
- 15. *Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors.”*

For assessing the reliability of the evidence obtained by the auditor from various sources, the auditor is guided by the principles enunciated in paragraph 7 of AAS 5.

- VI. The auditor, if he himself was not the auditor in the immediately preceding financial year, must apply the principles laid down in AAS 22²¹, “Initial Engagements - Opening Balances” while verifying the figures of opening balances.
- VII. Paragraph 4 of the AAS 28, “The Auditor’s Report on Financial Statements”, provides that the auditor’s report should contain a clear written expression of opinion on the financial statements taken as a whole. An unqualified opinion can be expressed only if the auditor is able to satisfy himself, by way of application of sufficient appropriate compliance and substantive procedures, that the financial statements give a true and fair view. The scope limitation imposed by lack of supporting evidence implies a particular emphasis on obtaining alternative corroborative evidence. However, if the auditor concludes that an unqualified opinion can not be expressed but the limitation on scope is not so material and pervasive as to require a disclaimer of opinion, a qualified opinion should be expressed. Further, a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements. Paragraph 45 of AAS 28 illustrates the principles enunciated here above. Having regard to the above, two illustrative formats of reporting by the auditor are given in

²⁰ Now known as Standard on Auditing (SA) 500.

²¹ Now known as Standard on Auditing (SA) 510.

the paragraphs 8 and 10 below for guidance of the members.

VIII. Illustrative audit report where the auditor decides to express a qualified opinion about the true and fair view of the financial statements:

I. (Where accounts have been reconstructed for some or all of the items for the whole financial year)

“We have audited the attached Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. We have been informed by the management that because of ____ (give reason) _____ the original accounts are not available for audit and hence these financial statements have been prepared from the reconstructed accounts prepared by the management. The accounts as well as the financial statements are the responsibility of the management. Our responsibility is to express an opinion on these financial statements based on our audit of the accounts.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We have not been able to obtain corroborative audit evidence supporting following items of the financial statements while auditing the accounts of the entity:

(State the areas for which the corroborative evidences were not available along with their quantification, to the extent possible and also their resultant effect on the financial statements.)

Subject to the above, the financial statements give a true and fair view:

- (i) in the case of the balance sheet, of the state of the _____ (name of the client) affairs as at the end of its financial year;
- (ii) in the case of the profit and loss account, of the profit or loss for its financial year; and
- (iii) In the case of the cash flow statement, of the cash flows for the year ended on that date.”

(ii) (where accounts have been reconstructed only for certain period during the year)

“We have audited the attached Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. We have been informed by the management that because of ____ (give reason) _____ the original accounts are not available for audit and hence these financial statements have been prepared from the reconstructed accounts prepared by the management for the period from ____ to ____ during the financial year. The accounts as well as the financial statements are the responsibility of the management. Our responsibility is to express an opinion on these financial statements based on our audit of the accounts.

(Other paragraphs shall be same as in the format given in Part I above.)

- IX. If the auditor is satisfied after obtaining a representation letter from the management and considering the results of sufficient appropriate audit procedures that the reconstruction of the accounts of the entity is not possible, he has no other option but to issue a disclaimer of opinion. The auditor should issue a report to the shareholders mentioning therein that it is not possible for him to express any opinion. The format of audit report to express disclaimer of opinion has been suggested in the following paragraph for guidance of the members.

- X. Illustrative audit report in situations where the reconstruction of the accounts is not possible:

“We were engaged to audit the Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date. The financial statements are the responsibility of the company’s management. The management of(name of the client) has informed us that owing to (state the reason for unavailability of records), the books of account and/ or other related records and documents of the (name of the client) have been completely destroyed. The management has also informed us that the reconstruction of the accounts is also not possible.

Since we have not been able to examine the books of account as well as the financial statements of(name of the client), we are unable to form any opinion on the financial statements.”

- XI. Members’ attention is also invited to the opinion given by the Expert Advisory Committee in September 1988 in situation of an audit where the records etc., had been seized by the income tax authorities and released after four years and records were reconstructed for the interregnum. The Committee, apart from the opinion on the type of the opinion to be expressed by the auditor in such cases, has also opined that the auditor should not normally rely on the management’s certificate as to the opening balances unless the information therein can be corroborated by other supporting document.

4. Amendment to SQC 1 - Retention Period for Engagement Documentation* (Working Papers)

Paragraph 83 of the Standard on Quality Control (SQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, states as follows:

“83. *The needs of the firm for retention*

.....

.....

*In the specific case of audit engagements, the retention period ordinarily is **no shorter than ten years** from the date of the auditor’s report, or, if later, the date of the group auditor’s report.” (emphasis added)*

The Council of the Institute of Chartered Accountants of India, at its 289th meeting held on August 19, 2009 at New Delhi, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007, has decided to amend paragraph 83 of the SQC 1 as follows:

* Issued in August, 2009.

“83. *The needs of the firm for retention*

.....
.....

*In the specific case of audit engagements, the retention period ordinarily is **no shorter than seven years** from the date of the auditor’s report, or, if later, the date of the group auditor’s report.” (emphasis added)*

5. Requirement to include the registration number of the firm as allotted by ICAI, in the audit reports signed by members of the ICAI*

The Council of the Institute of Chartered Accountants of India (ICAI), at its 292nd meeting held on January 13, 2010 has decided to require the members of the Institute of Chartered Accountants of India to:

- Include, in addition to the other requirements relating to signature on the audit report, as prescribed under the relevant Standard on Auditing, the registration number of the firm as allotted by ICAI, in the audit reports signed by them ; and
- Ensure that the resolution passed by the company regarding appointment of the statutory auditor of the company under section 224 of the Companies Act, 1956, also contain the registration number of the firm of the auditor(s) with the ICAI.
- These requirements would come into effect from April 1, 2010.

6. Amendment to SA 230- Retention Period for Engagement Documentation (Working Papers)**

Consequential Amendment to Audit Documentation Retention Period in Standard on Auditing (SA) 230, Audit Documentation

The Council of the Institute of Chartered Accountants of India had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of Standard on Quality Control 1 to seven years.

As a consequence of the above decision of the Council, with the issuance of this announcement by the Auditing and Assurance Standards Board, the audit documentation retention period appearing as ten years in paragraph A23 of the Standard on Auditing (SA) 230, Audit Documentation, issued in January 2009, shall also stand amended to seven years.

7. Requirement to mention the firm registration number allotted by ICAI in all reports issued, including certificates, by members of the ICAI***

Attention of the members is invited to the announcement regarding requirement relating to mentioning the firm registration number in the audit reports and resolution passed by the company for appointment of statutory auditors, published on page 1312 of the February 2010 issue of the Journal.

The Council of the Institute of Chartered Accountants of India, in terms of the decision taken at the 296th meeting held in June 2010 has decided to extend the requirement to mention the firm registration number to all reports issued pursuant to any attestation engagement, including certificates, issued by

* Issued in January, 2010.

** Issued in May, 2010.

*** Issued in August, 2010.

the members as proprietor of/ partner in the said firm. The requirement shall apply where such firm registration number has been allotted by the Institute of Chartered Accountants of India.

The Council further decided to make this requirement effective for all attestation reports/ certificates issued on or after 1st October, 2010.

8. Manner of Reporting by the Auditors on Prudential Regulatory Treatment Prescribed by RBI In Respect of Pension and Gratuity Liability of Public Sector Banks*

1. As the members are aware, the Reserve Bank of India on 9th February 2011 had issued a circular (no. DBOD.BP.BC.80/21.04.018/2010-11) on *Re-opening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits – Prudential Regulatory Treatment*. In terms of the said circular, “the banks may take the following course of action in the matter:
 - a. *The expenditure, as indicated in paragraph 2 above, may, if not fully charged to the Profit and Loss Account during the financial year 2010-11, be amortised over a period of five years {subject to (b) and (c) below} beginning with the financial year ending March 31, 2011 subject to a minimum of 1/5th of the total amount involved every year.*
 - b. *Consequent upon the introduction of International Financial Reporting Standards (IFRS) from April 1, 2013 for the banking industry as scheduled, the opening balance of reserves of banks will be reduced to the extent of the unamortised carry forward expenditure.*
 - c. *The unamortised expenditure carried forward as aforementioned shall not include any amounts relating to separated/retired employees.*
 - d. *Appropriate disclosures of the accounting policy followed in this regard may be made in the Notes to Accounts to the financial statements.
.....”*
2. The Council of the Institute of Chartered Accountants of India at its 304th meeting held on 23rd March 2011 considered the prudential regulatory treatment prescribed by the Reserve Bank of India vide its above mentioned circular *vis a vis* the impact thereof on the auditor’s report since the said treatment is a departure from the requirements of the Accounting Standard (AS) 15, *Employee Benefits*.
3. On a consideration of the matter, the Council of the Institute decided that since the accounting treatment for such expenditure is prescribed under the prudential regulatory framework of the Regulator, the auditors need not qualify their audit report on account of this. The matter should, however, be brought out by the auditors in the audit report by way of an “Emphasis of Matter Paragraph” in accordance with the Standard on Audit (SA) 706, “*Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report*, provided the matter of departure from the requirements of AS 15 pursuant to the aforesaid circular of RBI is appropriately disclosed, with quantification, by the bank by way of the notes to the accounts in the financial statements.

* Issued in April, 2011.

4. An illustrative Emphasis of Matter Paragraph in the audit report is as follows:

“Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X to the financial statements, which describes deferment of pension and gratuity liability of the bank to the extent of Rs. YYY pursuant to the exemption granted by the Reserve Bank of India to the public sector banks from of application of the provisions of Accounting Standard (AS) 15, Employee Benefits vide its circular no. DBOD. BP.BC/80/21.04.018/2010-11 on Re-opening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits – Prudential Regulatory Treatment.”

5. Members may note that the aforesaid disclosure in the Notes to the Accounts would normally include:

- Quantification of the actual amount of pension liability arising on account of exercise of the pension option by the employees of the bank who had not opted for pension earlier;
- Quantification of the actual amount of additional liability arising on account of the amendment to the Payment of Gratuity Act, 1972; and
- Impact on the financial statements of application of the provisions of AS 15 in the given circumstances had such circular not been issued by RBI.

An illustrative Note to Accounts in this regard is as follows:

“During the year, the Bank reopened the pension option for such of its employees who had not opted for the pension scheme earlier. As a result of exercise of which by BBB (number of employees), the bank has incurred a liability of Rs. XXX. Further, during the year, the limit of gratuity payable to the employees of the banks was also enhanced pursuant to the amendment to the Payment of Gratuity Act, 1972. As a result the gratuity liability of the Bank has increased by Rs. ZZZ.

In terms of the requirements of the Accounting Standard (AS) 15, Employee Benefits, the entire amount of Rs. AAA (ie. Rs. XXX + Rs. ZZZ) is required to be charged to the Profit and Loss Account. However, the Reserve Bank of India has issued a circular no. DBOD.BP.BC.80/21.04.018/2010-11) on Re-opening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits – Prudential Regulatory Treatment, dated 9th February 2011. In accordance with the provisions of the said Circular, the Bank would amortise the amount of Rs. AAA over a period of five years. Accordingly, Rs. CCC (representing one-fifth²² of Rs. AAA) has been charged to the Profit and Loss Account. In terms of the requirements of the aforesaid RBI circular, the balance amount carried forward, ie., Rs. YYY (Rs. AAA – Rs. CCC) does not include any employees relating to separated/ retired employees.

Had such a circular not been issued by the RBI, the profit of the bank would have been lower by Rs. YYY pursuant to application of the requirements of AS 15.”

²² The said RBI circular requires that the amount of amortisation should be at least one-fifth of the total amount involved every year.

9. Compliance with Paragraphs 61 and 62 of the Standard on Review Engagements (SRE) 2410*

1. The Council of the Institute of Chartered Accountants of India, at its 308th meeting, considered an issue relating to difficulties being faced by the members of the Institute in compliance with paragraphs 61 and 62 of the SRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, raised by the Auditing and Assurance Standards Board of the Institute.
2. The Council noted that paragraphs 61 and 62 of SRE 2410 require as under:

“61. The terms of the engagement include management’s agreement that where any document containing interim financial information indicates that such information has been reviewed by the entity’s auditor, the review report will also be included in the document. If management has not included the review report in the document, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances.

62. If the auditor has issued a modified review report and management issues the interim financial information without including the modified review report in the document containing the interim financial information, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances, and the possibility of resigning from the appointment to audit the annual financial statements.”
3. The Council noted that a number of entities were publishing interim financial results with a declaration that the “results have been approved by the Board of Directors at its meeting held on xxxxx and have been subjected to limited review by the statutory auditors.” The companies, however, were not publishing the review report along with such published results. Accordingly, it was either that the auditors had not obtained an agreement with the management that they would publish the review report along with the reviewed results or that despite the said agreement, the management had not complied therewith. The Council noted that in the latter cases, the auditor would be penalised under the requirements of SRE 2410 even when the default/ breach had been committed by the management.
4. The Council was of the view that it is not practically feasible for the auditor to ensure that every document released by the management containing the interim financial information indicating that such information has been reviewed by the entity’s auditor, the review report has been included in the said document.
5. On a consideration of the matter, the Council is of the opinion that paragraphs 61 and 62 did not envisage the auditor to take steps to ensure that on every occasion when the review results were published by the management, it also published the review report therewith. The responsibility of the auditor was upto issuance of the review report on the results, at most till the time the interim results, along with the review report, were filed by the company with the concerned stock exchange. Further, since such filing led to the concerned interim results and the review report thereon becoming available in the public domain, the same would be construed as sufficient compliance by the auditor with the requirements of paragraphs 61 and 62 of SRE 2410.

* Issued in October, 2011.

6. The Council, however, felt that if, subsequent to the issuance of the review report, the auditor became aware of situations where the management had not published the review report especially where the review report contained auditor's reservations, he would need to bring the same to the attention of the management and, if considered necessary, take legal advice.

10. Statutory Auditor's Reporting Responsibilities in Respect of Depositing of Cess Pursuant to Clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and Section 227(3)(g) of the Companies Act, 1956*

1. The Council of the Institute, at its 312th meeting held on December 25 - 27, 2011, noted that paragraph 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 required the statutory auditor to report on the matter relating to regularity of the company in depositing undisputed statutory dues as follows:

"Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Service Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.[Paragraph 4(ix)(a)]"

2. The Council also noted that paragraph 63(g) of the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India states as follows:

*It may be noted that at present, no Rules relating to the amount of cess for rehabilitation or revival or protection of assets of sick industrial companies, payable by a company under section 441A of the Act have been notified by the Central Government. Thus, it would not be possible for the auditor to comment on the regularity or otherwise about the cess till the time relevant rules or regulations are issued. **However, till the time such Rules are prescribed, the auditor should also state in his report under this clause that the Government has not notified any Rules under section 441A of the Companies Act, 1956 and, therefore, the auditor is unable to comment on this particular issue.** (emphasis added)*

3. The Council noted that till date the Central Government had not notified the effective date of section 441A of the Companies Act, 1956. Consequently, no Rules thereunder had also been prescribed by the Central Government. Accordingly, there was no question of reporting thereon under the Companies (Auditor's Report) Order, 2003. The Council, therefore, decided that in view of the aforementioned situation, the statutory auditor need not report in respect of cess payable under section 441A of the Companies Act, 1956 as envisaged under paragraph 63(g) of the Statement on the Companies (Auditor's Report) Order, 2003. The Council, therefore, decided to modify paragraph 63(g) of the said Statement as follows:

"It may be noted that at present, no Rules relating to the amount of cess for rehabilitation or revival or protection of assets of sick industrial companies, payable by a company under section 441A of the Act have been notified by the

* Issued in January, 2012.

Central Government. Thus, it would not be possible for the auditor to comment on the regularity or otherwise about the cess till the time relevant rules or regulations are issued. ~~However, till the time such Rules are prescribed, the auditor should also state in his report under this clause that the Government has not notified any Rules under section 441A of the Companies Act, 1956 and, therefore, the auditor is unable to comment on this particular issue.~~ However, till the time such Rules are prescribed, the auditor need not make any comment in respect of the Cess under section 441A of the Companies Act, 1956 in his report under paragraph 4(ix)(a) of CARO 2003.

4. The Council, incidentally, also noted that section 227(3)(g) of the Companies Act, 1956 required the statutory auditor's report to state, "Whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid." It was also noted that the operative date of even section 227(3)(g) had not yet been notified by the Central Government.
5. Accordingly, as a corollary to the Council's views on auditor's reporting responsibilities on cess under section 441A of the Companies Act, 1956, pursuant to clause 4(ix)(a) of CARO, 2003, the Council was of the view that the statutory auditor's report need not contain any comment on section 227(3)(g) of the Companies Act, 1956.

11. Important Announcement on revised Effective Date/ Applicability of three Standards on Auditing, namely:*

- SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";
- SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
- SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

During the last few weeks, the President and Vice-President, during their interaction with members especially statutory central and branch auditors of banks, business community and Council Members, have been urged that concerted efforts be made by the Institute by way of regular CPE and other programmes to familiarise the practicing members with the requirements of the following three Standards on Auditing namely:

- SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";
- SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
- SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

which were issued in 2010 to be effective/applicable for audits of financial statements for the periods beginning on or after 1.4.2011 and only after ensuring adequate education, publicity and familiarization, the said standards, be made mandatory.

The above concerns were shared by the President and Vice-President among other Council colleagues and thereafter based on the view emerged, the President directed the office to circulate a proposal, under Regulation 165, among Council Members for taking a decision on postponement by one year of the applicability of aforementioned Standards on Auditing.

Accordingly, a proposal for postponement by one year of the effective date/applicability of the

* Issued in April, 2012.

above mentioned three Standards on Auditing was circulated among Council Members for taking a decision in the matter, in accordance with the applicable provisions of Regulation 165 of the Chartered Accountants Regulations 1988. The decision so taken by the Council is as follows:

“The Council, in partial modification of the decision taken by it at its 291st meeting held in December, 2009, decided that the effective date/applicability of the following Standards on Auditing –

- a) SA 700 (Revised), “Forming an Opinion and Reporting on Financial Statements”;
- b) SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”;
- c) SA 706, “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”

be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided and referred to above).

The suggestion of some members on issue of suitable clarification in respect of those members who have since issued the audit reports in consonance with the said Standards i.e. under new format, shall be brought before the Council at its next meeting for addressing the same appropriately.”

This is for information and compliance of all concerned.

12. Manner of Reporting by the Statutory Auditors on Accounting for Liabilities Arising on Dismantling of Indian Motor Third Party Insurance Pool (IMTPIP) Prescribed by IRDA*

1. As the members are aware, the Insurance Regulatory and Development Authority (IRDA) had *vide* its Order No. IRDA/NL/ORD/MPL/277/12/2011 dated 23rd December 2011 had directed the dismantling of the Indian Motor Third Party Insurance Pool (IMTPIP) with effect from 31st March 2012.
2. Subsequently, *vide* its Order No. IRDA/F&A/ORD/MTPP/070/03-2012 dated 22nd March 2012, in exercise of its powers under section 34 of the Insurance Act, 1938, prescribed, *inter alia*, the following accounting treatment in respect of the “transitional liabilities” relating to the financial years 2009-10, 2010-11 and 2011-12, arising on account of such dismantling as follows:

“3. The IMPTPIP liabilities upon estimation/re-estimation of actuarially determined liabilities relating to the financial years (accounting years as the practice is) 2009-10, 2010-11 and 2011-12 following the dismantling of the IMTPIP shall be determined and such determined liabilities (Transitional Liabilities) shall be recognized by insurers by making an irrevocable choice to recognize the said transitional liabilities:

- a. *Immediately in the financial year ending March, 2012; or*
- b. *As an expense on a straight-line basis over upto the three years beginning with the financial year ending March, 31, 2012.*
- c. *An insurer opting for (b) above, shall:*

* Issued in May, 2012.

- (i) *Disclose at the end of each financial year the amount of transitional liabilities that remains unrecognized; and the amount recognized in the financial year; and*
 - (ii) *Shall ensure that the expense to be recognized in subsequent years shall not be less than the expense that shall fall due on a straight-line basis; and*
 - (iii) *In case the actual liability in respect of past years i.e. underwriting years until March, 31, 2012 being more than the amount on straight-line basis, such additional liabilities shall be recognized in full, in addition to the amount falling due for recognition on straight-line basis."*
3. The Council of the Institute of Chartered Accountants of India at its 316th meeting held from 15th to 17th May 2012 considered the accounting treatment prescribed under paragraph 3(b) of the above mentioned Order of IRDA *vis a vis* the impact thereof on the auditor's report since non-recognition of the said liability where an insurer exercises the option under paragraph 3(b) is not in accordance with accounting principles generally accepted in India.
4. On a consideration of the matter, the Council of the Institute noted that the aforesaid accounting treatment has been prescribed by the IRDA in exercise of its powers under section 34 of the Insurance Act, 1938. Accordingly, the statutory auditors need not qualify their audit report on account of such accounting treatment followed by the insurance company. The matter should, however, be brought out by the auditors in the audit report by way of an "Emphasis of Matter Paragraph" in accordance with the Standard on Audit (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report, provided the non-recognition of the said liability pursuant to the aforesaid order of IRDA is appropriately disclosed, with quantification, by the insurer by way of the notes to the accounts in the financial statements.
5. An illustrative Emphasis of Matter Paragraph in the audit report is as follows:

"Emphasis of Matter Without qualifying our opinion, we draw attention to Note X to the financial statements, which describes deferment of the liability on dismantling of the Indian Motor Third Party Insurance Pool by the Company to the extent of Rs. YYY pursuant to the exercise of the option for the accounting treatment for the same prescribed under paragraph 3(b) of Insurance Regulatory and Development Authority Order no. IRDA/F&A/ORD/MTAP/070/03/2012 dated 22nd March 2012. "
6. Members may note that the aforesaid disclosure in the Notes to the Accounts would normally include.
 - Quantification of the actual amount of the total liability on dismantling.
 - amount of transitional liabilities that remains unrecognized; and
 - the amount recognized in the financial year;
7. Further, pursuant to dismantling of the IMTPIP by the IRDA, the insurance company's accounting policy for recognition of liability incurred by it in respect of third party risks of specified commercial motor vehicles (specified risks) would also undergo a change. Accordingly, the Company would also need to appropriately disclose such change in accounting policy in its Notes to Accounts. An illustrative disclosure in this respect is this regard is also given below.

8. An illustrative Notes to Accounts in respect of treatment of liability arising on account of dismantling of IMTPIP for the financial years 2007-08 and 2008-09 and the transitional liability in respect of the financial years 2009-10, 2010-11 and 2011-12 is as follows:

“During the year, the Insurance Regulatory and Development Authority *vide* its Orders No. IRDA/NL/ORD/MPL/277/ 12/2011 dated 23rd December 2011 directed the dismantling of the Indian Motor Third Party Insurance Pool (IMTPIP).

Subsequently, the IRDA *vide its Order No.* IRDA/F&A/ORD/ MTPP/070/03-2012 dated 22nd March 2012, in exercise of its powers under section 34 of the Insurance Act, 1938, prescribed, the following accounting treatment in respect of the liability arising on account of the dismantling of the IMTPIP:

“2. The additional IMPTPIP liabilities upon re-estimation of actuarially determined liabilities relating to underwriting years 2007-08 and 2008-09 shall be accounted for and recognized in full in the financial year ending March 31, 2012 itself. The Pool Manager shall quantify the liability in respect of each insurer for this purpose.

3. The IMPTPIP liabilities upon estimation/re-estimation of actuarially determined liabilities relating to the financial years (accounting years as the practice is) 2009-10, 2010-11 and 2011-12 following the dismantling of the IMTPIP shall be determined and such determined liabilities (Transitional Liabilities) shall be recognized by insurers by making an irrevocable choice to recognize the said transitional liabilities:

- (a) *Immediately in the financial year ending March, 2012; or*
 (b) *As an expense on a straight-line basis over upto the three years beginning with the financial year ending March, 31, 2012.”*

As a result of dismantling of the IMTPIP, the Company has incurred the following liability:

2007 – 08	:	Rs. DDD	(as quantified by the Pool Manager)
2008 – 09	:	Rs. GGG	(as quantified by the Pool Manager)
Total		(A): Rs. JJJ	

Transitional Liability

2009-10	:	Rs. PPP	
2010-11	:	Rs. QQQ	
2011-12	:	Rs. TTT	
Total Transitional liability	(B):	Rs. AAA	

TOTAL LIABILITY ON ACCOUNT

OF DISMANTLING (A) + (B) : Rs. HHH

Accordingly, in terms of the requirements of paragraph 2 of IRDA’s Order of 22nd March 2012, an amount of Rs. JJJ has been charged to the Profit and Loss Account for the current financial year ended 31st March 2012.

Further, the Company has decided to exercise the option given under paragraph 3(b) of the aforesaid Order of IRDA in respect of the accounting treatment of

Transitional Liability amounting to Rs. AAA and, thus, would amortize the amount of Rs. AAA over a period of three years. Accordingly, Rs. CCC (representing one-third of Rs. AAA) has been charged to the Profit and Loss Account for this financial year. Further, in terms of the requirements of paragraphs 3(b) and (c) of the aforesaid Order of IRDA, the balance amount carried forward is Rs. YYY (Rs. AAA – Rs. CCC).

Had the Company chosen to exercise the option given under paragraph 3(a) of the aforesaid Order of the IRDA, the Company would have been required to recognise the entire amount of Transitional Liability of Rs. AAA in its Profit and Loss Account for the year 2011-12. Accordingly, the profit of the company would have been lower by Rs. YYY pursuant to recognition of the said liability in the year of dismantling of IMTPIP.”

9. An illustrative Notes to Account in respect of change in the accounting policy in respect of third party risks of specified commercial motor vehicles is as follows:

“Till the financial year 2010-11, the Company had the following accounting policy in respect of respect of third party risks of specified commercial motor vehicles (specified risks):

(state the policy hitherto being followed by the company)

Pursuant to the dismantling of the IMTPIP by the IRDA with effect from 31st March 2012, with effect from 1st April, 2012, it would not be possible for the Company to transfer the risks incurred by it on account of third party risks of specified commercial motor vehicles by way of reinsurance of same through IMTPIP. Accordingly, the Company would be required to provide for the entire amount of related liability and also recognize the entire amount of other related expenditure in the financial statements of the relevant financial year.”

13. Manner of Reporting on Section 227(3)(bb) of the Companies Act, 1956*

- I. Section 227(3)(bb) of the Companies Act, 1956 requires the statutory auditor to report on the following aspect:

“bb. whether the report on the accounts of any branch office audited under section 228 by a person other than the company’s auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor’s report;”

(A similar reporting requirement appears in section 143(3)(c) of the Companies Act, 2013 though the section has not yet been notified by the Central Government”.)

- II. The Council of the Institute, at its 329th (Adjourned) meeting held on 03rd and 04th January 2014 at New Delhi noted that reporting by the statutory auditors of the Company on clause (3)(bb) of section 227 of the Companies Act, 1956 is a legal requirement in cases where the company had appointed separate branch auditor/s. However, the same was inadvertently not appearing under the “Report on Other Legal and Regulatory Requirements” paragraph in the illustrative format of the independent auditor’s report for a Company as given in the Appendix to SA 700. The Council

* Issued in February, 2014.

** The Section has been notified after the issuance of this announcement.

accordingly, decided to add the following reporting in the illustrative independent auditor's report formats for a Company (to be reported upon as and where applicable):

“bb. the report on the accounts of the branch offices audited under section 228 by a person other than the company's auditor has been forwarded to us as required by clause (c) of sub-section (3) of section 228 and have been dealt with in preparing our report in the manner considered necessary by us;”

14. Reference to the Accounting Standards Applicable to the Companies in the Auditor's Report and Limited Review Reports and various Engagement Standards*

- I. The Ministry of Corporate Affairs (MCA) has *vide* its notification dated 12th September 2013 notified 98 sections of the Companies Act 2013 having come into force from that date. One of the sections so notified is Section 133 which empowers the Central Government to prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India (ICAI) in consultation with and after examination of the recommendation by the National Financial Reporting Authority (NFRA).
- II. Subsequently, MCA *vide* its General Clarification No. 15/2013 dated 13th September 2013, has clarified that to facilitate proper administration of the notified sections of the Companies Act 2013, in respect of the aforesaid Section 133, “*Till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority, the existing Accounting Standards, notified under the Companies Act, 1956 shall continue to apply.*”
- III. Further, *vide* its Circular no. 16/2013 dated 18th September 2013, MCA has further clarified that with effect from 12th September 2013, “*the relevant provisions of the Companies Act, 1956, which correspond to provisions of 98 sections of the Companies Act, 2013 brought into force on 12.09.2013, cease to have effect from that date.*” As a result, section 211(3C) of the Companies Act, 1956 corresponding to which section 133 of the Companies Act, 2013 has been notified has ceased to have effect from 12th September, 2013.
- IV. In view of the above, members have sought guidance on the manner of reference to the Accounting Standards applicable to the company in the statutory auditor's report of the company as well as the limited review report in case of a listed company, issued pursuant to clause 41 of the Listing Agreement.
- V. The matter was considered by the Council of the Institute of Chartered Accountants of India at its 329th Adjourned meeting held on 03rd and 04th January 2014 at New Delhi. The Council noted that in so far as the format of the auditor's report for a statutory audit of a company, for example, as given in illustration 1 in Appendix to SA 700, is concerned, reference to the Accounting Standards issued under section 211 (3C) of the Companies Act, 1956 appears at two places. First, under the “*Management's Responsibility for the Financial Statements*” paragraph and second, under the “*Report on Other Legal and Regulatory Requirements*” paragraph.
- VI. The Council noted that, while section 133 of the Companies Act, 2013 had been notified, and accordingly, section 211(3C) of the Companies Act, 1956 had been superceded, section 143 of the Companies Act, 2013, which dealt with the matters to be contained in the auditor's report, had not yet been notified*. Accordingly, the auditor's reporting requirements were still being governed by section 227(3) of the Companies Act, 1956 and that clause 227(3)(d) of the Companies Act,

* The Section has been notified after the issuance of this announcement.

1956 requires the auditors to report “*whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211*” of the Companies Act, 1956.

- VII.** The Council is of the view that in the above background, till the time section 143 of the Companies Act, 2013 is made operative, both the following manners of making reference to the Accounting Standards in the independent auditor’s report of a Company would be acceptable:

Alternative 1: Refer to section 211(3C) of the Companies Act, 1956 (both in the “Management’s Responsibility for Financial Statements” and “Report on Legal and Other Regulatory Matters” paragraphs (*as currently given in the illustrative format of independent auditor’s report for a company given in Appendix to SA 700*);

OR

Alternative 2: Refer to only the Companies Act, 1956 along with the reference to the relevant notifications of MCA *vide* which it had clarified that the Accounting Standards prescribed under the Companies Act, 1956 would continue to apply in respect of section 133 of the Companies Act, 2013.

- VIII.** Where the members decide to opt for *Alternative 2* above, the “Management Responsibility for Financial Statements” paragraph and the “Report on Legal and Other Regulatory Matters” paragraph in the independent auditor’s report would need to suitably reworded as follows and such rewording would be construed to be in accordance with that prescribed in the text/ Appendix to the concerned Engagement Standard.

“Management’s Responsibility for the Financial Statements

Management iscash flows of the Company in accordance with the Accounting Standards notified under the Companies Act, 1956 (“the Act”) read with the General Circular 15/2013 dated 13th September 2013 of the Ministry of Corporate Affairs in respect of section 133 of the Companies Act, 2013. This responsibility..... fraud or error.”

“Report on Other Legal and Regulatory Requirements

2. As required by Section 227(3) of the Act, we report that:

(a)
.....

(d) In our opinion, the Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement comply with the Accounting Standards notified under the Companies Act, 1956 read with the General Circular 15/2013 dated 13 September 2013 of the Ministry of Corporate Affairs in respect of section 133 of the Companies Act, 2013.

.....

(f)”

- IX.** Similarly, in case of limited review reports issued in terms of clause 41 of the Listing Agreement, approach similar to as suggested above may also be adopted while making a reference to the Accounting Standards applicable to the concerned Company in the limited review report/s issued by a practitioner pursuant to the Standard on Review Engagement (SRE) 2400, *Engagements to Review Financial Statements* or the Standard on Review Engagement (SRE) 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.

15. Amendment to the “Auditor’s Responsibility” Paragraph Included in the Independent Auditor’s Report*

1. The Council of the Institute of Chartered Accountants of India at its 329th Adjourned meeting held on 03rd and 04th January 2014, New Delhi noted that in the context of the “auditor’s responsibility”, paragraph 31(b) of the Standard on Auditing (SA) 700, *Forming An Opinion and Reporting on Financial Statements*, issued by the Institute, required the following to be mentioned in the auditor’s report:

“31. The auditor’s report shall describe an audit by stating that:

- (b) The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor’s consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and”

(emphasis added)

2. The Council noted that the “Auditor’s Responsibility” paragraph as given in the illustrative formats of the independent auditor’s report, as given in the Appendix to SA 700 (and as a corollary, in the Appendices to SA 705²³ and SA 706²⁴), however, did not contain such description that the auditor’s risk assessment and procedures were not designed for the purpose of expressing an opinion on the effectiveness of the entity’s internal controls.
3. The Council, accordingly, decided to amend the “Auditor’s Responsibility” paragraph in an independent auditor’s report as follows:

“An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.”

(the amendment is shown in the track changed mode)

* Issued in February, 2014.

²³ SA 705, Modifications to the Opinion in the Independent Auditors Report.

²⁴ SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report.

16. Use of the Term “Profit and Loss Account” or “Statement of Profit and Loss” in the Statutory Audit Reports of Companies*

- I. The Council of the Institute of Chartered Accountants of India, at its 329th Adjourned meeting, held on 03rd and 04th January, 2014 at New Delhi noted that the illustrative formats of the independent auditor’s report (in respect of a Company) as given in SA 700, SA 705 and SA 706 contain the references to “Profit and Loss Account” at various places. The term was being used since the Schedule VI to the Companies Act, 1956 also used this term.
- II. The Council also noted that though the Revised Schedule VI to the Companies Act, 1956 as also the corresponding Schedule III to the Companies Act, 2013, instead use the term “Statement of Profit and Loss”, section 227 of the Companies Act, 1956, which continues to be applicable in respect of the statutory auditor’s reporting requirements, used the term “Profit and Loss Account”.
- III. The Council decided that in view of the above, in the independent auditor’s report of a Company, the auditors may chose to use the term “Profit and Loss Account” or “Statement of Profit and Loss”.

17. Manner of Reporting In Respect of Such Clauses of the Companies (Auditor’s Report) Order, 2003 Which Are Not Applicable to the Auditee Company*

- I. The Council, at its 329th Adjourned meeting held on 03rd and 04th January 2014 at New Delhi noted that the paragraph 80 of the Statement on the Companies (Auditor’s Report) Order, 2003 (the Statement) requires that, in such situations, where one or more of the clauses are not applicable, it would be appropriate for the auditor to make a suitable comment in his report bringing out the fact of non-applicability of a particular clause.
- II. The Council considered the requirements of paragraph 80 of the Statement and was of the view that non applicability of one or more clauses of the Companies (Auditor’s Report) Order, 2003 (CARO 2003) to the company would not, in any way, impact the auditor’s opinion on the financial statements. Thus, the said information did not have much perceivable benefit to the readers of the audit report. Accordingly, the auditor may choose to report on the non-applicability of the individual clause of CARO, 2003, or, alternatively, aggregate/ club the fact of non applicability of different clause(s) of CARO 2003.
- III. The Council, accordingly, decided to amend paragraph 80 of the Statement on CARO, 2003 as follows:

80. There may be situations where one or more of the clauses are not applicable. For example, the requirement regarding internal audit system does not apply in case of all the companies. In such situations, it would be appropriate for the auditor to make a suitable comment in his report bringing out the fact of non-applicability of a particular clause. To illustrate, where the maintenance of cost records has not been prescribed by the Central Government under section 209(1)(d) of the Act, the auditor may state:

“The Central Government has not prescribed maintenance of cost records under section 209(1)(d) of the Companies Act, 1956 for any of the products of the company”.

Alternatively, the auditor may aggregate/ club the fact of non applicability of different clauses of CARO, 2003 and report as under:

* Issued in February, 2014.

"Matters specified in clauses.....(relevant clause number of the clause/s not applicable) of paragraph 4 of the CARO 2003 do not apply to the Company."

(note: Amendments to paragraph 80 of the Statement on CARO, 2003 are given in track changed mode).

18. Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s)*

1. An independent auditor of the financial statements of an entity may, at times, need to rely upon work of the other auditors. For example, in an audit of the stand alone financial statements of an entity the independent auditor thereof (the Principal Auditor) may need to rely upon the financial statements of the entity's component/s such as branch/es, division/s, etc., which have been audited by other independent auditor/s. Similarly, in an audit of the consolidated financial statements of a group, the independent auditor thereof (the Principal Auditor), may need to rely upon the work of the independent auditors of the components of the group such as subsidiary/ies, joint venture/s, associate/s, etc., whose audited financial statements/ information have been included in the consolidated financial statements and have been audited by their respective independent auditors (the Component Auditors).
2. There may also be a situation where the financial statements of one or more components included in the stand alone financial statements of an entity/ consolidated financial statements of a group have not been audited either by the Principal Auditor or the Component Auditor/s.
3. Members have sought guidance on the appropriate manner of disclosure of information in the independent auditor's report of the Principal Auditor about the fact that the financial statements/ information pertaining to certain/ all components, included in the stand alone financial statements of an entity/ consolidated financial statements of a group are unaudited.
4. The Council at its 331st meeting held on 10th February, 2014 considered the above matter and decided as under:

Situation 1 Component/s is/ are unaudited and such component/s is/ are not material to the financial statements of the entity/ consolidated financial statements of the Group

Situation 2 Component/s is/ are audited by auditor/s other than the Principal Auditor and such component/s is/ are not material to the financial statements of the entity/ consolidated financial statements of the Group

Disclosures in the Principal Auditor's Report

The principal auditor may or may not disclose the fact of such component/s in the Principal Auditor's report. In case the Principal Auditor decided to make such disclosure, the same would be done under the "Other Matters" paragraph, pursuant to SA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. An illustrative manner of reporting is given in Illustration 2 in the Appendix to SA 706.

* Issued in February, 2014.

Situation 3	Component/s is/ are audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the financial statements of the entity/ consolidated financial statements of the Group	The principal auditor would need to disclose the fact of such component/s in the Principal Auditor's report. Such disclosure would be done under the "Other Matters" paragraph, pursuant to SA 706, <i>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report</i> . An illustrative manner of reporting is given in Illustration 2 in the Appendix to SA 706.
Situation 4	Component/s is/ are unaudited and such component/s is/ are material to the financial statements of the entity/ consolidated financial statements of the Group	The Principal Auditor needs to consider its/ their impact on the auditor's opinion on the financial statements of the entity/ consolidated financial statements of the group, in terms of the principles laid down in SA 705, <i>Modifications to the Opinion in the Independent Auditor's Report</i> .

5. Further, in case of the auditor's reports of the statutory central auditors, the manner of disclosure about the audited/ unaudited components as given in the illustrative formats of the auditor's report in the Guidance Note on Audit of Banks would continue to apply.

19. Applicability of the Companies Act, 2013 to Auditor's Report to FY 2014-15 and Onwards*

The Ministry of Corporate Affairs, on 26th March 2014 notified a majority of the remaining sections of the Companies Act, 2013, including sections 139 to 148, relating to audits and auditors. The Act was stated to be effective from 1st April, 2014.

Accordingly, queries are being raised by a number of members as to whether any auditor's report of a company being signed on or after 01st April, 2014 would be in accordance with the requirements of section 143 of the Companies Act, 2013.

In this context, it may be noted that the Ministry of Corporate Affairs (MCA) has, on 04th April 2014, *vide* its General Circular No. 08/2014, clarified that the financial statements (and documents required to be attached thereto), auditor's report and Board's report in respect of financial years that commenced earlier than 01st April, 2014 shall be governed by the relevant provisions/Schedules/rules of the Companies Act 1956. This MCA Circular can be seen at URL http://www.mca.gov.in/Ministry/pdf/General_Circular_8_2014.pdf.

Therefore, it is clear from MCA's aforesaid General Circular that the auditor's report of a company pertaining to any financial year commencing on or before 31st March 2014, would be in accordance with the requirements of the Companies Act, 1956 even if that financial year ends after 01st April 2014. For example, where the financial year of a company is 01st January 2014 to 31st December 2014, the statutory auditor's report signed therefor would be in accordance with the requirements of the Companies Act, 1956.

* Issued in April, 2014.

As a corollary to MCA's General Circular, it appears that the provisions of the 2013 Act would apply only to the financial years commencing on or after 01st April 2014. Thus, for example, the statutory auditor's report signed in respect of the financial year of the company ended 31st March 2015 would need to be issued in accordance with the provisions of the Companies Act, 2013.

20. Manner of Reporting by the Auditors In Respect of RBI's Circular on Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961*

1. The Reserve Bank of India, on 20th December 2013, issued Circular No. DBOD. No.BP.BC.77/21.04.018/2013-14 for all commercial banks (excluding Regional Rural Banks) in respect of Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961.
2. RBI, in its aforesaid Circular has noted that some banks were not creating deferred tax liability (DTL) on Special Reserve as per Accounting Standard 22, 'Accounting for taxes on Income' (AS 22) on the grounds that they do not intend to withdraw from such Reserve in the future. In many cases banks have formalised such intent by having resolutions passed by their Boards or Committees to this effect.
3. RBI, *vide* its aforesaid Circular, has required that as a matter of prudence, banks should create DTL on such Special Reserve. Further, for this purpose, banks may take the following course of action:
 - a) If the expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 has not been fully charged to the Profit and Loss account, banks may adjust the same directly from Reserves. The amount so adjusted may be appropriately disclosed in the Notes to Accounts of the financial statements for the financial year 2013-14.
 - b) DTL for amounts transferred to Special Reserve from the year ending March 31, 2014 onwards should be charged to the Profit and Loss Account of that year.
4. RBI Circular also states that in view of the requirement to create DTL on Special Reserve, banks may reckon the entire Special Reserve for the purpose of computing Tier-I Capital.
5. The Council of ICAI has considered the impact of the accounting dispensation prescribed by RBI with respect to treatment of expenditure on creation of DTL as at 31st March 2013 (as referred to in paragraph 3.a above) on the report of the banks' statutory auditors.
6. On a consideration of the matter, the Council is of the view that any specific accounting treatment prescribed by a regulator, even if at variance with the Accounting Standard/s, was an integral part of the financial reporting framework applicable to the entity falling under the jurisdiction of such regulator and the entity would be required to follow such prescribed accounting treatment. Accordingly, the statutory auditors need not modify their audit opinion in respect of such prescribed accounting treatment. However, the fact may be brought out by the statutory auditors in their audit report by way of an "Emphasis of Matter" paragraph in accordance with the Standard on Audit (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", issued by ICAI, provided the matter of departure from the requirements of the Accounting Standard/s pursuant to the aforesaid regulatory requirement is appropriately disclosed, with quantification, by the entity by way of the notes to the accounts in the financial statements.

* Issued in April, 2014.

7. An illustrative “Emphasis of Matter” paragraph is as follows:

“Emphasis of Matter

We draw attention to Note X to the financial statements, which describes the accounting treatment of the expenditure on creation of Deferred Tax Liability on Special Reserve under section 36(1)(viii) of the Income Tax Act, 1961 as at 31st March 2013, pursuant to RBI’s Circular No. DBOD. No.BP.BC.77/21.04.018/2013-14 dated 20th December 2013. Our opinion is not qualified in respect of this matter.”

8. The aforesaid disclosure in the Notes to the Accounts would normally include the following information in respect of creation of Deferred Tax Liability (DTL) on Special Reserve for the following:
- Amount of expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 not fully charged to the Profit and Loss Account as adjusted directly against Reserves
 - Impact on Profit & Loss Account had the amount of hitherto unprovided DTL been charged to the Profit and Loss Account instead of Reserves directly as required by the RBI Circular.

9. An illustrative Note to Accounts in this regard is as follows:

“Pursuant to Reserve Bank of India’s (RBI’s) Circular No. DBOD. No.BP.BC.77/21.04.018/2013-14 dated 20th December 2013, the Bank has created Deferred Tax Liability on the Special Reserve under section 36(1)(viii) of the Income-tax Act, 1961. As required by the said RBI Circular, the expenditure, amounting to Rs. XXXX due to the creation of DTL on Special Reserve as at March 31, 2013, not previously charged to the Profit and Loss Account, has now been adjusted directly from the Reserves. Had this amount been charged to the Profit & Loss Account in accordance with the generally accepted accounting principles in India, the amount of Profit for year had been lower/ amount of Loss for the year higher²⁵ by such amount.”

21. Applicability of The Provisions of Section 143(3)(i) of The Companies Act 2013 and The Related Rules*

Section 143(3)(i) of the Companies Act 2013 requires the auditors of the companies to report as whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

The Council of the Institute of Chartered Accountants of India, at its adjourned 333rd meeting held on 18th June 2014, considered the issue of applicability of the provisions of sections 143(3)(i) of the Companies Act 2013 and the related Rules to the audits of the periods beginning on or before 31st March 2014.

The Council noted that the sections 143(3)(i) had come into force in respect of financial years beginning on or after 1st April 2014. The Council was of the view that the provisions of sections 143(3)(i) of the Companies Act 2013 applied to the auditors appointed under the Companies Act 2013 to audit the financial statements for the year beginning on or after 1st April 2014. As a corollary, the requirements of these sections and related Rules would not apply to audits of financial statements of the periods beginning on or before 31st March 2014, even if the audits therefor were actually carried out

²⁵ As the case may be.

* Issued in June, 2014.

and auditor's report thereon issued on or after 1st April 2014. These would continue to be done as per the requirements of the Companies Act 1956.

The Council also decided that as a corollary, the provisions of section 143(3)(i) of the Companies Act 2013 would apply to the audits of the financial year beginning on or after 1st April 2014.

22. *Applicability of The Provisions of Section 143(12) of The Companies Act 2013 and The Related Rules to Periods Beginning on or Before 31st March 2014**

Section 143(12) of the Companies Act 2013 requires the auditors of the companies to report to the Central Government on the frauds committed or being committed against the company.

The Council of the Institute of Chartered Accountants of India, at its adjourned 333rd meeting held on 18th June 2014, considered the issue of applicability of the provisions of sections 143(3)(12) of the Companies Act 2013 and the related Rules to the audits of the periods beginning on or before 31st March 2014.

The Council noted that the sections 143(12) had come into force in respect of financial years beginning on or after 1st April 2014. The Council was of the view that the provisions of sections 143(12) of the Companies Act 2013 applied to the auditors appointed under the Companies Act 2013 to audit the financial statements for the year beginning on or after 1st April 2014. As a corollary, the requirements of these sections and related Rules would not apply to audits of financial statements of the periods beginning on or before 31st March 2014, even if the audits therefor were actually carried out and auditor's report thereon issued on or after 1st April 2014.

23. *Applicability of Section 143(12) to Financial Years Beginning on or After 1st April 2014**

The Council of the Institute of Chartered Accountants of India, at its adjourned 333rd meeting held on 18th June 2014, considered the issue of applicability of the provisions of section 143(12) of the Companies Act 2013 to the financial periods beginning on or after 1st April 2014. In other words, whether the statutory auditor would be required to report pursuant to section 143(12) while carrying out audits of financial statements for the interim periods, such as quarterly or half yearly audits.

The Council was of the view that such quarterly/ half yearly audits are not carried out pursuant to the requirements of the Companies Act 2013 (rather to meet the specific requirements of the auditee company, for example, to comply with the listing agreement requirements) as the latter only envisages audit of the annual financial statements.

The Council, accordingly, felt that prima facie, as a corollary, section 143(12) would become applicable only for financial year (and not for a period) 2014-2015 and onwards. The Council is, however, in the process of communicating with the Ministry of Corporate Affairs in this regard.

24. *Illustrative Formats of the Engagement Letter for Audit of Financial Statements under the Companies Act, 2013 and the Rules Thereunder@*

The Auditing and Assurance Standards Board is issuing the following illustrative formats for engagement letter for audit of Financial Statements under the Companies Act, 2013 and the Rules thereunder. These illustrative formats were approved by the Council of the Institute of Chartered Accountants of India (ICAI) at its meeting held in November 2014. These illustrative formats would be added to the Appendix 1 of Standard on Auditing (SA) 210, 'Agreeing the Terms of Audit Engagements', issued by ICAI.

* Issued in June, 2014.

@ Issued in December, 2014.

Illus. 1	Engagement Letter for Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder (When Reporting u/s 143(3)(i) is Applicable) ²⁶
Illus. 2	Engagement Letter for Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder (When Reporting u/s 143(3)(i) is not Applicable) ²⁶

25. Illustrative Formats of the Independent Auditor's Report on Standalone Financial Statements under the Companies Act, 2013 and the Rules Thereunder*

The Auditing and Assurance Standards Board is issuing the following illustrative formats of the Independent Auditor's Report on the Standalone Financial Statements under the Companies Act, 2013 and the Rules thereunder. These illustrative formats were approved by the Council of the Institute of Chartered Accountants of India (ICAI) at its meeting held in November 2014. These illustrative formats would be added to the respective Appendices of Standard on Auditing (SA) 700, Forming An Opinion and Reporting On Financial Statements and Standard on Auditing (SA) 705, Modifications to the Opinion in the Independent Auditor's Report, issued by ICAI.

Illus. 1	Unmodified Opinion on Standalone Financial Statements, Emphasis of Matter Paragraphs, Reporting on clause 143(3)(i) regarding internal financial controls is required ²⁷	<i>Will be added to Appendix to SA 700</i>
Illus. 2	Unmodified Opinion on Standalone Financial Statements, Emphasis of Matter Paragraphs, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁷	
Illus. 3	Qualified Opinion on Standalone Financial Statements, Qualification is quantifiable, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	<i>Will be added to Appendix to SA 705</i>
Illus. 4	Qualified Opinion on Standalone Financial Statements, Qualification is not quantifiable, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	
Illus. 5	Adverse Opinion on Standalone Financial Statements, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	
Illus. 6	Disclaimer of Opinion on Standalone Financial Statements, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	

The Board is in consultation with the Ministry of Corporate Affairs with respect to issues pertaining to the independent auditor's report on consolidated financial statements under the Companies Act 2013. Accordingly, the illustrative format of the independent auditor's report on consolidated financial statements under the Companies Act, 2013 will be issued in due course.

²⁶ These formats have been included as a part of Appendix 1 to SA 210, "Agreeing the Terms of Audit Engagements", published elsewhere in Volume I.A of the Handbook.

* Issued in December, 2014.

²⁷ These formats have been included as a part of Appendix to SA 700, "Forming an Opinion and Reporting on Financial Statements", published elsewhere in Volume I.A of the Handbook.

²⁸ These formats have been included as a part of Appendix to SA 705, "Modifications to the Opinion in the Independent Auditor's Report", published elsewhere in Volume I.A of the Handbook.

26. Announcement on CARO, 2003 and Additional Reporting Under the Companies Act, 2013*

We are receiving queries from the members regarding applicability of CARO, 2003 along with Auditors' Report on financial statements of companies for the financial year 2014-15. The Ministry of Corporate Affairs (MCA) is working on it and has constituted a Committee for this purpose to analyse the contents of the Order to be made under section 143(11) of the Companies Act, 2013 for the Financial Year 2014-15. ICAI is also a member of the said committee. We are given to understand by MCA that an Order being a smaller version of CARO 2003, applicable for the financial year 2014-15, may be notified soon under section 143(11) of the Companies Act, 2013. However, at this juncture, to bring more clarity, this Announcement is released in consultation with the Ministry.

The Companies Act, 1956 has ceased to have effect from 01st April, 2014. As a corollary, the Companies (Auditor's Report) Order, 2003 issued under section 227(4A) of the said Act also ceases to have effect from the said date.

Section 143(11) of the Companies Act, 2013 which came into force from 01st April, 2014 provides that "the Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein."

Accordingly, it may be noted that as when an Order is notified by the Central Government under section 143(11) of the Companies Act, 2013, the members would be required to report thereon as a part of their statutory audit reports.

Until the aforesaid Order is issued, no additional reporting under section 143(11) of the Companies Act, 2013 is required by the Auditors for the financial year 2014-15.

Members are advised to keep a watch on the MCA site (www.mca.gov.in) as well as the ICAI site (www.icaai.org) for further announcements in this regard.

27. *Guidance on Reporting Under the Companies (Auditor's Report) Order, 2015 (CARO, 2015) and Consequential Amendment to the Format of the Auditor's Report of a Company*²⁹

I. Reporting Under CARO, 2015

1. As the members are aware, the Ministry of Corporate Affairs, on 10th April, 2015, notified the Companies (Auditor's Report) Order, 2015 (CARO, 2015). The text of the Order is available on the URL http://www.mca.gov.in/Ministry/pdf/Companies_Auditors_Report_Order_2015.pdf.

2. Members would have noted that, inter alia, the exemption criteria applicable to private companies as laid down in the paragraph 1(v) of the CARO, 2015 is same as that in the Companies (Auditor's Report) Order, 2003 (CARO, 2003). Also, it is noted that the twelve reporting clauses given in paragraph 3 of CARO, 2015 are similar in their requirements to the corresponding clauses in paragraph 4 of the CARO, 2003. Further, the requirement to state reasons for unfavourable or qualified answers as given in paragraph 4 of the CARO, 2015 is also similar to that contained in paragraph 4 of the

* Issued in April, 2015.

* Issued in April, 2015.

²⁹ This Announcement is being issued in terms of the decision taken at the 342nd meeting of the Council of the Institute of Chartered Accountants of India.

CARO, 2003. Accordingly, members are advised to continue to draw in principle guidance from the relevant paragraphs of the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

3. For the benefit of the members, following is a reference table of reporting clauses of CARO, 2015 and the corresponding paragraphs of the Statements on CARO, 2003, wherefrom relevant guidance can be drawn (subject to necessary changes in the context of the provisions of the Companies Act, 2013 and the Rules issued thereunder):

Clause of CARO, 2015	Relevant Paragraph/s of the Statement on CARO, 2003
(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;	44(a) to (n)
(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;	45(a) to (g)
(ii)(a) whether physical verification of inventory has been conducted at reasonable intervals by the management;	47(a) to (d)
(b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;	48(a) to (k)
(c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;	49(a) to (h)
(iii) whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act. If so,	50(a) to (f)
(a) whether receipt of the principal amount and interest are also regular; and	52(a) to (e)
b) if overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest	53(a) to (c)
(iv) is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system.	57(a) to (m)
(v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to	60(a) to (l)

<p>76 or any other relevant provisions of the Companies Act and the rules framed there under, where applicable, have been complied with? If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?</p>	
<p>(vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, whether such accounts and records have been made and maintained;</p>	<p>62(a) to (g)</p>
<p>(vii) (a) is the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.</p>	<p>63(a) to (r)</p>
<p>(b) in case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).</p>	<p>64(a) to (h)</p>
<p>(c) whether the amount required to be transferred to investor education and protection fund in accordance with the relevant provisions of the Companies Act, 1956 (1 of 1956) and rules made thereunder has been transferred to such fund within time.</p>	<p>The members may note that the provisions relating to the Investor Education and Protection Fund (IEPF) are contained in section 205C of the Companies Act, 1956 and the IEPF (Awareness and Protection of Investors) Rules, 2001. For the purpose of reporting on this clause, the members would need to examine the date of transfer <i>vis a vis</i> the time prescribed in the aforesaid provisions and Rules and report accordingly.</p>
<p>(viii) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the</p>	<p>65(a) to (h)</p>

financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;	
(ix) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;	66(a) to (h)
(x) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;	71(a) to (h)
(xi) whether term loans were applied for the purpose for which the loans were obtained;	72(a) to (j)
(xii) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.	77(a) to (k)

4. Members may also continue to draw guidance, to the extent relevant, in respect of applicability of the CARO, 2015, form of report and Board's report, from the guidance given in the Statement on Companies (Auditor's Report) Order, 2003 (subject to necessary changes in the context of the provisions of the Companies Act, 2013 and the Rules thereunder).

II. Consequential Amendment to the Format of the Auditor's Report of A Company

5. The Auditing and Assurance Standards Board had, in December 2014, issued illustrative formats of the auditor's report on financial statements of a company under the Companies Act, 2013. While reporting on the requirements of CARO, 2015, a reference thereto also needs be added in the main audit report under the "Report on Legal and Other Regulatory Matters" paragraph as follows:

"Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2015 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143 (3) of the Act, we report that:

.....
"

The aforesaid illustrative formats of the auditor's report, accordingly, stand amended to that extent.

28. *Clarification on Auditor's Report in respect of Financial Statements of a Company for Accounting Years Beginning Before 1st April, 2014³⁰

1. The Ministry of Corporate Affairs vide its General Circular No 07/2014, *Dissemination of Information With Regards to the Provisions of the Companies Act, 2013 as Notified Till Date vis a vis Corresponding Provisions of the Companies Act, 1956*, dated 01st April 2014 had provided information in respect of such sections of the Companies Act 1956 which will cease/continue to have effect after 01st April 2014 (i.e. the date when a number of sections of the Companies Act 2013 came into force).

2. Also, the Ministry of Corporate Affairs had on 04th April, 2014 issued a General Circular No. 8/2014 regarding "Commencement of provisions of the Companies Act 2013 with regard to maintenance of books of accounts and preparations/adoption/filing of financial statements, auditor's report, Board's report and attachments to such statements and reports - Applicability with regard to relevant financial Year".

3. The aforesaid General Circular of 04th April 2014 *inter alia*, mentioned that "..... it is hereby notified that the financial statements (and documents required to be attached thereto), auditor's report and Board's report in respect of financial years that commenced earlier than 1st April, 2014 shall be governed by the relevant provisions/ Schedules/ rules of the Companies Act, 1956 and that in respect of financial years commencing on or after 1st April, 2014, the provisions of the new Act shall apply."

4. Also, such companies whose financial years ended at a date other than 31st March, are in the process of aligning their financial year to meet the definition of "financial year" as per the Companies Act, 2013.

5. The matters described in paragraph 1 above have given rise to a situation wherein, with effect from 01st April 2014, the various documents, minutes and registers, etc., are being maintained by companies in accordance with the provisions of the Companies Act, 2013. Consequently, in case of companies whose financial years commenced before 31st March 2014 but would end on or before 31st March 2015, w.e.f. 01st April 2014, various documents, minutes and registers, etc., may not be maintained in accordance with the provisions of the Companies Act, 1956 for such part of the financial year that falls after 01st April 2014 (i.e., the date when the Companies Act, 2013 comes into force).

6. The aforesaid situation is giving rise to practical difficulties for the statutory auditors while reporting in terms of certain provisions of section 227 of the Companies Act, 1956 in respect of the companies described in paragraph 5 above since necessary documents, minutes and registers, etc., under the Companies Act, 1956 may not be available for such part of the financial year that falls after 01st April 2014. Specifically, these difficulties relate to reporting under section 227(3)(f), relating to disqualification of the Directors under section 274(1)(g) of the Companies Act 1956. Similarly, problems would be faced while reporting on certain clauses of the Companies (Auditor's Report) Order, 2003 (CARO 2003). For example, clause (iii) relating to loans to/from parties covered in the register maintained under section 301 of the Companies Act 1956; or clause (v)(a) and (b) relating to contracts or arrangements referred to in section 301 of the Companies Act 1956; or clause (vi) relating to provisions of section 58A and 58AA of the Companies Act, 1956 relating to acceptance

* Issued in April, 2015.

³⁰ This "Clarification" was approved by the Council of the Institute of Chartered Accountants of India at its 342nd meeting held on 15-16 April, 2015.

of deposits from the public; or clause (viii) relating to maintenance of cost records; or clause (xiv) relating to dealing or trade in shares, securities, debentures, other investments, etc *vis a vis inter alia*, exemption under section 49 of the Companies Act, 1956 or clause (xviii) relating to preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Companies Act, 1956. It may also be noted that in terms of MCA's aforesaid General Circular No 07/2014, of 01st April, 2014, sections 49, 58A, 58AA, 209, 274, 301 of the Companies Act, 1956 cease to have effect from 01st April 2014.

7. It is, therefore, suggested that in case of aforesaid situation, the statutory auditors should report on the relevant clauses only for that part of the financial year upto which the concerned provisions of the Companies Act 1956 were in force (i.e. upto 31st March 2014). Also, the statutory auditors should clearly bring out this fact in the relevant portions of their audit reports. An illustrative manner of such disclosure is as follows:

“Other Matters

The Ministry of Corporate Affairs had on 01st April, 2014, *vide* its General Circular No. 07/2014, *Dissemination of Information with Regards to the Provisions of the Companies Act, 2013 as Notified Till date vis a vis Corresponding Provisions of the Companies Act, 1956*, identified such sections of the Companies Act, 1956 that would cease/ continue to have effect from 01st April 2014.

Accordingly, in terms of the aforesaid Circular, our reporting in respect of section 227(3)(f) of the Companies Act, 1956, and clauses (iii), (v)(a) and (b), (vi), (viii), (xiv), (xviii) of the Companies (Auditor's Report) Order, 2003 (dealing with sections 49, 58A, 58AA, 209(1)(d) and 301 of the Companies Act, 1956) is only for the period beginning from ie (date) till 31st March 2014 since as per the aforementioned MCA Circular these sections have ceased to have effect from 01st April, 2014.”

8. This Announcement is effective from the date of its hosting on ICAI's website.

29. Auditor's Report on Consolidated Financial Statements Under The Companies Act, 2013*

The Auditing and Assurance Standards Board, under the authority of the Council, has already issued the illustrative formats of the auditor's report on standalone financial statements of a company under the Companies Act 2013 in December 2014. While reporting on the consolidated financial statements (CFS) of a company under the Companies Act 2013, the auditors may draw guidance from the aforementioned formats and suitably reword the same, as required, to meet the circumstances of audit of CFS. The auditors of CFS, while reporting in respect of the provisions of, *inter alia*, section 143(3) and section 143(11) of the Companies Act, 2013 in their report on CFS, are also advised to:

- consider the observations and comments as given in this regard in the auditors' reports of the component auditors.
- include in their report or draw suitable reference to, negative/adverse comments, if any, in respect of section 143(3) and section 143(11) of the Act relating to a component, as appearing in the component auditors' report.

* Issued in May, 2015.

36 Auditing Pronouncements

The auditors of CFS are also advised to apply concept of materiality and professional judgment as provided in the Standards on Audit while reporting on the Consolidated Financial Statements.

The following illustrative formats of an auditors' report on CFS, covering some of the clauses of section 143(3) of the Companies Act, 2013 (and where the auditor does not have the responsibility for reporting on internal financial controls over financial reporting under section 143(3)(i) of the Companies Act, 2013), are being issued herewith just to provide a broad guidance on how such a report may be prepared. These formats may be applied for the FY 2014-15 and until further announcement. It is reiterated that the auditors of CFS may suitably reword/redraft these formats to suit the circumstances of their audit engagement.

Type of Format	
Unmodified opinion on the consolidated financial statements ³¹	This format will be added in the Appendix to SA 700
Modified opinion on the consolidated financial statements ³²	This format will be added in the Appendix to SA 705

D. List of Mandatory Statements and Standards on Auditing

I. List of Statements on Auditing as on 01.10.2015

- Statement on the Companies (Auditor's Report) Order, 2003 (Revised 2005).³³
- Statement on Reporting under section 227 (1A) of the Companies Act, 1956³⁴.

II. List of Engagement and Quality Control Standards as on 01.10.2015

Quality Control						
Standard Number (SQC) (1-99)	Standards on Quality Control (SQC)	Published in Journal	Date from which effective			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011
1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	October 2007		✓		

³¹ The format has been included as a part of Appendix to SA 700, "Forming an Opinion and Reporting on Financial Statements", published elsewhere in Volume I.A of the Handbook.

³² The format has been included as a part of Appendix to SA 705, "Modifications to the Opinion in the Independent Auditor's Report", published elsewhere in Volume I.A of the Handbook.

³³ Issued in April, 2004 pursuant to the issuance of the Companies (Auditor's Report) Order, 2003. The revised edition issued in April 2005 pursuant to the issuance of the Companies (Auditor's Report) (Amendment) Order, 2004.

³⁴ The Council, at its 269th meeting held from July 18, 2007 to July 20, 2007, decided to withdraw the Statement on Qualifications in Auditor's Report except paragraphs 2.1 to 2.30 dealing with reporting under section 227 (1A) of the Companies Act, 1956 and to rename the Statement as 'Statement on Reporting under section 227 (1A) of the Companies Act, 1956'.

Audits and Reviews of Historical Financial Information						
Standard Number (SA) (100-999)	Standards on Auditing (SAs)		Date from which effective			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011
100-199	Introductory Matters					
200-299	General Principles and Responsibilities					
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	March 2010			✓	
210	Agreeing the Terms of Audit Engagements	September 2009			✓	
220	Quality Control for an Audit of Financial Statements	March 2010			✓	
230	Audit Documentation	January 2009		✓		
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	December 2007		✓		
250	Consideration of Laws and Regulations in an Audit of Financial Statements	December 2008		✓		
260	Communication with Those Charged with Governance	December 2008		✓		
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	December 2009			✓	
299	Responsibility of Joint Auditors		Effective for all audits related to accounting periods beginning on or after April 1, 1996			
300-499	Risk Assessment and Response to Assessed Risks					
300	Planning an Audit of Financial Statements	December 2007	✓			
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	February 2008	✓			
320	Materiality in Planning and Performing an Audit	August 2009			✓	
330	The Auditor's Responses to Assessed Risks	February 2008	✓			
402	Audit Considerations Relating to an Entity Using a Service Organisation	August 2009			✓	

38 Auditing Pronouncements

450	Evaluation of Misstatements Identified during the Audit	August 2009			✓	
500–599	Audit Evidence					
500	Audit Evidence	April 2009			✓	
501	Audit Evidence - Specific Considerations for Selected Items	March 2010			✓	
505	External Confirmations	March 2010			✓	
510	Initial Audit Engagements—Opening Balances	March 2009			✓	
520	Analytical Procedures	March 2010			✓	
530	Audit Sampling	February 2009			✓	
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	February 2009			✓	
550	Related Parties	March 2009			✓	
560	Subsequent Events	January 2009			✓	
570	Going Concern	December 2008			✓	
580	Written Representations	October 2008			✓	
600-699	Using Work of Others					
600	Using the Work of Another Auditor		Effective for all audits related to accounting periods beginning on or after April 1, 2002			
610	Using the Work of Internal Auditors	August 2009			✓	
620	Using the Work of an Auditor's Expert	March 2010			✓	
700-799	Audit Conclusions and Reporting					
700*	Forming an Opinion and Reporting on Financial Statements	February 2010				✓
705*	Modifications to the Opinion in the Independent Auditor's Report	February 2010				✓
706*	Emphasis of Matter Paragraphs and Other Matter	February 2010				✓

* The Council of the ICAI, in partial modification of the decision taken by it at its 291st meeting held in December 2009, has decided that the effective date/applicability of the three standards viz SA 700 (Revised), SA 705 and SA 706 be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided). The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

	Paragraphs in the Independent Auditor's Report						
710	Comparative Information - Corresponding Figures and Comparative Financial Statements	April 2010					✓
720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 2009			✓		
800-899	Specialized Areas						
800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	April 2010					✓
805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 2010					✓
810	Engagements to Report on Summary Financial Statements	April 2010					✓
Standard Number (SRE) (2000-2699)	Standards on Review Engagements (SREs)	Published in Journal	Date from which effective				
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011	
2400	Engagements to Review Financial Statements	May 2010			✓		
2400 (Revised)	Engagements to Review Historical Financial Statements		Effective for reviews of financial statements for periods beginning on or after April 1, 2016.				
2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity	May 2010			✓		
Assurance Engagements Other Than Audits or Reviews of Historical Financial Information							
Standard Number (SAE) (3000-3699)	Standards on Assurance Engagements (SAEs)	Published in Journal	Date from which effective				
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011	
3000-3399	Applicable to all Assurance Engagements						
3400-3699	Subject Specific Standards						
3400	The Examination of		Effective in relation to reports on				

40 Auditing Pronouncements

	Prospective Financial Information		projections/ forecasts, issued on or after April 1, 2007			
3402	Assurance Reports on Controls at a Service Organisation	April 2011				✓
Related Services						
Standard Number (SRS) (4000-4699)	Standards on Related Services (SRSs)		Date from which effective			
4400	Engagements to Perform Agreed-upon Procedures Regarding Financial Information		Applicable to all agreed upon procedures engagements beginning on or after April 1, 2004			
4410	Engagements to Compile Financial Information		Applicable to all compilation engagements beginning on or after April 1, 2004			
4410 (Revised)	Compilation Engagements		Effective for compilation engagements undertaken after March 31, 2016.			

PART – I : STANDARDS

Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹ (Effective from April 1, 2008)

Introduction

1. This Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services has been issued to facilitate understanding of the scope and authority of the pronouncements of the AASB issued under the authority of the Council of the Institute of Chartered Accountants of India (the ICAI).

2. The ICAI is committed to the goal of enabling the accountancy profession in India to provide services of high quality in the public interest and which are accepted worldwide. To further this goal, the ICAI develops and promulgates technical Standards and other professional literature. The ICAI being one of the founder members of the International Federation of Accountants (IFAC), the Standards developed and promulgated by the AASB under the authority of the Council of the ICAI are in conformity with the corresponding International Standards issued by the International Auditing and Assurance Standards Board (IAASB), established by the IFAC. The "Due Process" of the AASB for formulation of Standards, Statements, Guidance Notes and its other pronouncements is given in the **Appendix** to this Preface.

Standards Issued by AASB under the Authority of the Council of ICAI

3. The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

- (a) Standards on Auditing (SAs), to be applied in the audit of historical financial information.
- (b) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.
- (c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, other than audits and reviews of historical financial information.
- (d) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

4. Standards on Quality Control (SQC), issued by the AASB under the authority of the Council, are to be applied for all services covered by the Engagement Standards as described in paragraph 3 above.

A diagram containing the structure of the Standards issued by the Auditing and Assurance Standards Board under the authority of the Council is given as **Annexure** to this Preface.

Standards on Auditing

5. The Standards on Auditing (SAs) referred to in Paragraph 3(a) above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of SAs is set out in SA 200².

¹ Issued in July, 2007.

² SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

I.2 Auditing Pronouncements

Standards on Quality Control

6. SQCs are written to apply to firms³ in respect of all their services falling under the Engagement Standards issued by the AASB of ICAI. The authority of SQCs is set out in the introduction to the SQCs.

Other Standards

7. The other Engagement Standards identified in paragraph 3 (b) to (d) as well as Standards on Quality Control referred to in paragraph 4 contain basic principles and essential procedures (identified in **bold type** lettering and by the word “should”) together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures. Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself. An individual Standard should be read in the context of the objective stated in the Standard as well as this Preface. Any limitation of the applicability of a specific Standard is made clear in the Standard itself.

Statements on Auditing

8. Statements on Auditing are issued with a view to securing compliance by professional accountants on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. Statements are, therefore, mandatory.

General Clarifications

9. General Clarifications are issued by the Board under the authority of the Council of the Institute with a view to clarify any issues arising from the Standards. General Clarifications are mandatory in nature.

Professional Judgment

10. The nature of the Standards/Statements/General Clarifications requires the professional accountant⁴ to exercise professional judgment in applying them.

Authority Attached to Other Standards, Statements on Auditing and General Clarifications

11. It is the duty of the professional accountants to ensure that the Standards/Statements/General Clarifications are followed in the engagements undertaken by them⁵. The need for the professional accountants to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedure would be ineffective. If because of that reason, a professional accountant has not been able to perform an engagement procedure in accordance with any Standard/Statement/General Clarification, he is required to document how alternative procedures performed achieve the purpose of the procedure, and, unless

³ The term “firm” refers to a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

⁴ The term “professional accountant” refers to a member of the Institute of Chartered Accountants of India.

⁵ Members’ attention is invited to Clause 5 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, according to which a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity. Further Clause 7 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

otherwise clear, the reasons for the departure. Further, his report should draw attention to such departures. However, a mere disclosure in his report does not absolve a professional accountant from complying with the applicable Standards/Statements/General Clarifications⁶.

12. There may be a situation where a matter is covered both by a Standard as also by a Statement on Auditing. In such a situation, the Statement shall prevail till the time the Standard becomes mandatory. Once a Standard becomes mandatory, the concerned Statement or the relevant portion(s) thereof will automatically be withdrawn.

Guidance Notes

13. Guidance Notes are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council. Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard. Professional accountants should be aware of and consider Guidance Notes applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Guidance Note should be prepared to justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

14. The Board may also publish Technical Guides, Practice Manuals, Studies and other papers. Technical Guides are ordinarily aimed at imparting broad knowledge about a particular aspect or of an industry to the professional accountants. Practice Manuals are aimed at providing additional guidance to professional accountants in performing audit and other related assignments. Studies and other papers are aimed at promoting discussion or debate or creating awareness on issues relating to quality control, auditing, assurance and related service, affecting the profession. Such publications of the Board do not establish any basic principles or essential procedures to be followed in audit, review, other assurance or related services engagements, and accordingly, have no authority of the Council attached to them.

Material Modifications to the Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Addition

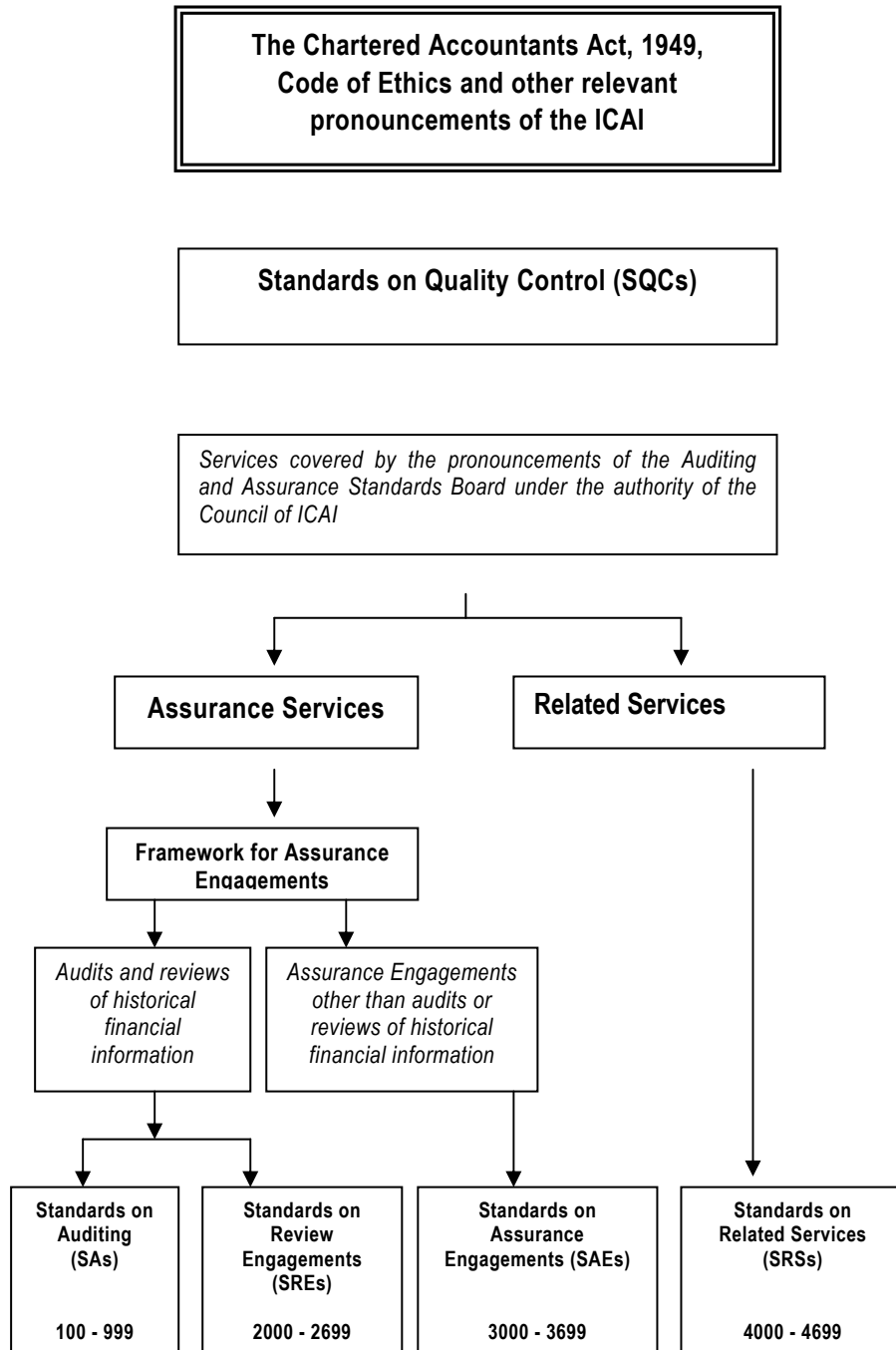
This Preface deals, apart from the Standards, with the Statements on Auditing and the General Clarifications as the mandatory documents for use by the professional accountants in performing engagements by them, whereas, the Preface issued by the IAASB does not deal with such aspects. Further, the nomenclature of International Auditing Practice Statements (IAPSs) referred in the Preface issued by the IAASB has been changed to Guidance Notes in this Preface.

Deletion

The Preface issued by the IAASB provides to include, in appropriate cases, additional considerations specific to public sector entities within the body of the Standard. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Preface does not deal separately with the public sector perspective.

⁶ Attention of the members is also drawn to Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, whereby, a member is deemed to be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted procedures of audit applicable to the circumstances.

Structure of Standards issued by the Auditing and Assurance Standards Board under the Authority of the Council of ICAI



Appendix

Auditing and Assurance Standards Board and its Due Process

Brief History

1. The Institute of Chartered Accountants of India (ICAI) constituted the Auditing Practices Committee (APC) on 17th September 1982, to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices so that these may be issued under the authority of the Council of the Institute. Subsequently, at its 226th meeting held in July 2002, the Council of the Institute approved certain recommendations of the APC to strengthen its role in the growth and development of the accountancy profession in India. The Council, at the said meeting, also approved the renaming of the Auditing Practices Committee as the Auditing and Assurance Standards Board (AASB) as well as renaming of the Statements on Standard Auditing Practices as Auditing and Assurance Standards (AASs).

2. The ICAI is one of the founder members of the International Federation of Accountants (IFAC). It is one of the membership obligations of the Institute to actively propagate the pronouncements of the International Auditing and Assurance Standards Board (IAASB) of the IFAC to contribute towards global harmonisation and acceptance of the Standards issued by the IAASB. Accordingly, while formulating Engagement and Quality Control Standards, the AASB takes into consideration the corresponding Standards, if any, issued by the IAASB. In addition, the AASB also takes into consideration the applicable laws, customs, usages and business environment prevailing in India within the parameters of the July 2006 Policy Paper, A Guide for National Standard Setters that Adopt IAASB's International Standards but Find it Necessary to Make Limited Modifications, issued by the IAASB.

Objectives and Functions of the Auditing and Assurance Standards Board

3. The following are the objectives and functions of the Auditing and Assurance Standards Board:
- (i) To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.
 - (ii) To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.
 - (iii) To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.
 - (iv) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.
 - (v) To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.
 - (vi) To formulate General Clarifications, where necessary, on issues arising from Standards.
 - (vii) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

Composition

4. The composition of the AASB is fairly broad-based and attempts to ensure participation of all interest groups in the standard-setting process. Apart from amongst the elected members of the Council of the ICAI the following are also represented on AASB:

- (i) Eminent members of the profession, whether in industry or in practice, as co-opted members on the Board.

I.6 Auditing Pronouncements

- (ii) One special invitee from each three regulatory bodies, viz., the Securities and Exchange Board of India, the Reserve Bank of India and the Insurance Regulatory and Development Authority.
- (iii) One special invitee from the Indian Institute(s) of Management, or from any other prominent academic and/or research organisation, as considered appropriate.
- (iv) One special invitee from a prominent Industry association.
- (v) One special invitee representing public interest, e.g., not for profit organization, etc.

The special invitees mentioned at (ii) through (v) above are decided in consultation with the President of the Institute. Further, special invitees do not constitute the members of the Board, as referred to in this document.

Term of the Members

5. The term of the Chairman of the Board is three years. Where such period of three years exceeds the term of the Council of ICAI during which the Chairman has been appointed, the term of the Chairman is restricted to the abovementioned term of the Council. The Council of the ICAI may fill any vacancy in the Office of the Chairman and the Chairman so appointed holds office for the unexpired term of the Council. The term of other members of the Board and the special invitees is one year. However, in case the period of one year exceeds the term of the Council during which the members have been appointed, the term of the members is restricted to the abovementioned term of the Council.

Attendance at the Meetings

6. Each AASB meeting requires the presence, in person, of at least one third of the members of the Board. However, the AASB meetings whereat a Standard or Statement, at whatever stage (as envisaged in the following paragraphs), is proposed to be considered, requires attendance of at least two thirds of the AASB members, in person or by simultaneous telecommunication link (such as teleconferencing, videoconferencing, etc.).

7. In case any member of the AASB absents himself from three consecutive meetings of the Board, without seeking leave of absence the AASB would bring such fact to the attention of the Council.

AASB Working Procedure

Standards, Statements on Auditing and General Clarifications

Project Identification, Prioritization and Approval

8. Project proposals to develop new, or revise existing Standards, Statements or General Clarifications are identified based on international and national developments, input from members of the Council of the ICAI, AASB members, members of other committees of the ICAI and/or recommendations received from other interested parties, such as regulators or professional accountants.

9. The AASB determines the priorities of various projects on hand for commencement.

10. In the preparation of Standards, Statements and General Clarifications, AASB is assisted by Study Groups/Task Forces constituted to consider specific projects. The AASB appoints one of the professional accountants as a convener of the Study Group/Task Force. The convener, in consultation with the Chairman, AASB, nominates other members of the Study Group/Task Force, ordinarily five to seven in number. For operating convenience and economy, a study group is usually based in the area where the convener is located. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such an expert need not necessarily be a professional accountant. The Study Group/Task Force is responsible for preparing the basic draft of the Standard/ Statement/ General Clarification. In addition, a separate group of experts may be formed to advice the Study Group /Task Force.

11. The AASB may also conduct projects jointly with regulators and/or others. In such cases, the joint Study Group/Task Force is ordinarily chaired by the convenor appointed with mutual consent.

Consultation and Debate

12. The Study Group/Task Force develops the preliminary draft of the Standard/ Statement/ General Clarification based on appropriate research and consultation, which may include, depending on the circumstances, consultation with the other professionals, regulators and other interested parties, as well as reviewing professional pronouncements issued by IFAC member bodies and other professional bodies. The draft submitted by the study group, along with issue papers/background papers, is sent to the Chairman, AASB for approval.

13. The draft Standard/Statement/General clarification, along with other agenda papers, as approved by the Chairman, is hosted on the website of the AASB, ordinarily, at least twenty one days in advance of the AASB meeting at which such draft Standard/ Statement is planned to be considered. A notification to that effect is also sent to the AASB members. The printed version of the agenda papers, including background papers and draft Standard/ Statement/General Clarification prepared by the Study Group/Task Force for review and debate are made available to the members of and special invitees to the AASB at the concerned meeting.

14. The AASB considers the preliminary draft of the Standard/ Statement/General Clarification prepared by the Study Group/Task Force. The AASB may refer the draft to the Study Group/Task Force to examine the issues arising out of the deliberations of the AASB and accordingly modify the draft Standard/ Statement/General Clarification.

15. In case the revision to the Standard/ Statement/General Clarification is made by the Study Group/ Task Force in terms of the requirements of paragraph 14 above, the procedure laid down in paragraphs 12 to 14 above is followed for the revised draft of the Standard/ Statement/General Clarification.

16. The draft of the proposed Standard/ Statement/General Clarification, as modified in the light of the deliberations of the Board and approved by the Chairman, AASB, is circulated to the Council members of the ICAI for their comments before being issued as an Exposure Draft. Normally, a period of ten days is given for receiving comments on the Draft Exposure Draft. AASB finalises the Exposure Draft of the proposed Standard/ Statement on the basis of the comments so received, if any. Ordinarily, an Exposure Draft of a General Clarification is not issued.

Public Exposure

17. The Exposure Draft of the proposed Standard / Statement is issued, by way of publication in the monthly Journal of the Institute and/or hosted on the website of the ICAI wherefrom it is downloadable free of charge, for comments by the professional accountants and the public. The Board, however, may decide not to issue an Exposure Draft of a Statement, in which case, the reasons for such a decision is recorded in the minutes of the relevant AASB meeting. Each Exposure Draft is, ordinarily, accompanied by an explanatory memorandum that highlights the objectives and significant proposals contained in the draft. The explanatory memorandum may also direct the respondents to those aspects of the Exposure Draft on which specific feedback is sought.

18. The Exposure Draft is sent to the members of the Council of the ICAI, the Institute's past Presidents, Regional Councils and their branches. Copies of the Exposure Draft are also sent to the following bodies:

- i. The Ministry of Company Affairs, Government of India
- ii. The Comptroller and Auditor General of India
- iii. The Reserve Bank of India

I.8 Auditing Pronouncements

- iv. The Insurance Regulatory and Development Authority
- v. The Central Board of Direct Taxes
- vi. The Central Board of Excise and Customs
- vii. The Securities and Exchange Board of India
- viii. The Central Registrar of Co-operative Societies
- ix. The Institute of Cost and Works Accountants of India
- x. The Institute of Company Secretaries of India
- xi. The Indian Banks Association
- xii. Industry organizations such as Federation of Indian Chambers of Commerce and Industry, Associated Chambers of Commerce, Confederation of Indian Industry
- xiii. Indian Institute(s) of Management
- xiv. The Telecom Regulatory Authority of India
- xv. The Standing Conference on Public Enterprises
- xvi. Recognised stock exchanges in India
- xvii. Any other body considered relevant by the AASB keeping in view the nature and requirement of AAS/Statement.

19. To allow adequate time for due consideration and comment from all interested parties, exposure period is ordinarily 45 (forty five) days or such other period, but not less than 45 days in any case, as may be decided by the AASB. Further, the exposure period would be reckoned from the date of hosting of the Exposure Draft on the website of the Institute.

Responses to Exposure Drafts and Consideration of Respondents' Comments

20. An acknowledgement is sent to every respondent to an Exposure Draft. Except where the respondent has specifically indicated otherwise, the respondents' comments are considered a matter of public records. Comments which are received upto ten days prior to the date of the AASB meeting at which such comments are proposed to be considered, are hosted on the website of the AASB and kept there till the date of the AASB meeting at which the Exposure Draft and comments thereon are considered. The members of the AASB as well as the Council of the Institute are notified when the comments are hosted on the website of the AASB. Copies of the Exposure Draft and comment letters are also made available to the AASB members at the AASB meeting at which the Exposure Draft is scheduled for discussion.

21. The comments and suggestions received within the exposure period are read and considered by the AASB. The AASB's deliberations on the significant issues raised in the comments letters received together with the AASB's decision thereon are recorded in the minutes of the relevant AASB meeting and also hosted on the website of the AASB. The AASB may decide to discuss with the respondents their comment letters or explain to them the reasons for not having accepted their proposals. The nature and outcome of such discussions are reported and recorded in the minutes of the relevant AASB meeting.

22. Such part of the AASB meetings whereat the Exposure Draft of proposed Standard/ Statement and the comments thereon are to be discussed is open for public. The members of the public, at their own expenditure, can attend the said part of the meeting(s) as observers. Such observers, however, do not have the right to participate in the discussions at the meeting. The notification as to the date of the said AASB meeting is hosted on the website of the Institute at least 30 days in advance and the members of the public desirous of attending the said meeting(s) are required to send their request for the same to the Board at least 15 days prior to the date of the concerned AASB meeting. The seats for the members of the public at such

meetings are limited to such numbers as may be decided by the AASB and allotted on a first come first serve basis. The AASB may also hold a meeting with the representatives of the specified bodies, as may be identified by the Board on a case to case basis, to ascertain their views on the draft of the proposed Standard/ Statement.

23. After taking into consideration the comments received, the draft of the proposed Standard/ Statement is finalized by the AASB and submitted to the Council of the ICAI for its consideration and approval. The draft of the General Clarification, as finalised by the AASB, is submitted to the Council of ICAI for its consideration and approval.

24. The Council of the ICAI considers the final draft of the proposed Standard/ Statement/General Clarification, and if found necessary, modifies the same in consultation with AASB. The concerned Standard/ Statement/ General Clarification is then issued under the authority of the Council of the ICAI.

Re-exposure

25. The AASB on a direction from the Council of the ICAI or on its own, in cases considered appropriate, may re-expose a proposed Standard/ Statement. The need for re-exposure may arise on account of factors such as significant issues coming to the notice of the Board subsequently, including, significant changes in the laws or regulations having an impact on the requirements of the Standard/ Statement or revision of the corresponding International Standard by IAASB. In cases where a re-exposure of a Standard or a Statement is required, the procedures as listed in paragraphs 12 to 24 are followed.

Procedure for Issuing the Guidance Notes

26. The AASB identifies the issues on which Guidance Notes need to be formulated and the priority in regard to selection thereof.

27. In the preparation of the Guidance Note, the AASB is assisted by Study Groups/Task Forces constituted to consider specific projects. The AASB appoints one of the professional accountants as a convenor of the Study Group / Task Force. The Convenor nominates other members of the Study Group/Task Force and in the formation of Study Groups / Task Forces, provision is made for participation of a cross-section of members of the ICAI. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such "expert" need not necessarily be a professional accountant. The Study Group/Task Force will be responsible for preparing the basic draft of the Guidance Note.

28. The Study Group/Task Force develops the preliminary draft of the Guidance Note based on appropriate research and consultation, which may include, depending on the circumstances, consulting with the other professionals, regulators and other interested parties, as well as reviewing professional pronouncements issued by IFAC member bodies and other parties and submits the preliminary draft Guidance Note to the AASB. The draft Guidance Note, along with the background papers, if any, is sent to the Chairman, AASB for approval.

29. The AASB considers the preliminary draft prepared by the Study Group/Task Force and may refer the same to the Study Group/Task Force to examine the issues arising out of the deliberations of the AASB and accordingly modify the draft Guidance Note. The modified Draft Guidance Note is once again considered by the Board. The draft Guidance Note as finalised by the Board is submitted for the consideration of the Council of the ICAI.

30. Unlike Standards/Statements, ordinarily, no proposed Guidance Note is exposed for comments of the professional accountants and others. However, in situations considered necessary by the Board, an Exposure Draft of a Guidance Note may well be issued for public comments. In case an Exposure Draft of a Guidance Note is to be issued, the same procedures as required for an Exposure Draft of the Standard/

I.10 Auditing Pronouncements

Statement (as mentioned in paragraphs 17 to 22 above) is required to be followed. The reasons for issuing an Exposure Draft of the Guidance Note are recorded in the minutes of the relevant AASB meeting. However, the part of the AASB meeting at such Exposure Draft is considered is not open for public.

31. The Council of the Institute considers the final draft of the proposed Guidance Note and, if necessary, suggests modifications thereto in consultation with the AASB. The Guidance Note is then issued under the authority of the Council of the ICAI.

Limited or Substantive Revision to the Standard, Statement or Guidance Note

32. Subsequent to issuance of a Standard, Statement or Guidance Note, the introduction of any new legal or professional requirement or any other national or international development in the field of auditing, may require a substantive revision to that Standard, Statement or Guidance Note. In that case, the Council of the ICAI makes substantive revision to such Standard/ Statement /Guidance Note. The procedure followed for substantive revision is the same as that followed for formulation of a new Standard, Statement or the Guidance Note, as the case may be, as detailed above.

33. Similarly, subsequent to issuance of a Standard, Statement or Guidance Note, some aspect(s) may require revision which are not substantive in nature. For this purpose, the Council of the ICAI may make limited revision to a Standard/ Statement /Guidance Note. In case of the Standards on Auditing (SAs), any revision to a Standard is treated as limited only if that revision is restricted to the application guidance of that Standard. The procedure followed for the limited revision is, in principle, the same as that followed for formulation of a Standard, Statement or Guidance Note, as the case may be. However, the AASB may decide to cut short some time limits, e.g. period of public exposure in case of a limited revision to a Standard/Statement, as detailed above, for the process.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

34. For issuance of a Technical Guides/Studies, etc., the procedure adopted by the AASB is ordinarily the same as in case of a Guidance Note except that the draft Technical Guide/ Practice Manual/ Study is not exposed for public comments nor such part of the AASB meeting at which the proposed Technical Guide, Practice Manual, etc., is considered, open for public. Also, since the Technical Guides, Practice Manuals, Studies, etc., are not issued under the authority of the Council, these are not required to be placed for consideration and final approval of the Council, and are issued by the AASB under its own authority.

Voting

35. The affirmative votes of a majority of the members of the Board, in person or by simultaneous telecommunication link, are required to approve the final draft of a Standard or Statement for submission to the Council.

36. Each member of the AASB has the right to one vote.

Glossary of Terms*

Access controls - Procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of “user authentication” and “user authorization.” “User authentication” typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. “User authorization” consists of access rules to determine the computer resources each user may access. Specifically, such procedures are designed to prevent or detect:

- (a) Unauthorized access to on-line terminal devices, programs and data;
- (b) Entry of unauthorized transactions;
- (c) Unauthorized changes to data files;
- (d) The use of computer programs by unauthorized personnel; and
- (e) The use of computer programs that have not been authorized.

Accounting estimate - An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where SA 540¹ addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.

Accounting records - The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

Accuracy Assertion - Amounts and other data relating to recorded transactions and events have been recorded appropriately.

Agreed-upon procedures engagement - An engagement in which an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures may misinterpret the results.

Analytical procedures - Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Annual report - A document issued by an entity, ordinarily on an annual basis, which includes its financial statements together with the auditor’s report thereon.

Anomaly - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Applicable financial reporting framework - The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

*Definitions given in this Glossary should be read in the context of the respective Standards where they are appearing.

¹ SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”.

I.12 Auditing Pronouncements

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.

Application controls in information technology - Manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Applied criteria (in the context of SA 810²) - The criteria applied by management in the preparation of the summary financial statements.

Appropriateness (of audit evidence) - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

Arm’s length transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Assertion-based Engagements - In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called “assertion-based engagements”.

Assertions - Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Assess - Analyze identified risks of to conclude on their significance. “Assess,” by convention, is used only in relation to risk. (also see *Evaluate*)

Association - (see *Auditor association with financial information*)

Assurance - (see *Reasonable assurance*)

Assurance engagement - An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria (also see *Subject matter information*). Under the “Framework for Assurance Engagements” issued by the Institute of Chartered Accountants of India there are two types of assurance engagement a

² SA 810, “Engagements to Report on Summary Financial Statements.”

practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

Reasonable assurance engagement—The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement³ as the basis for a positive form of expression of the practitioner's conclusion.

Limited assurance engagement—The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Assurance engagement risk - The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

Audit documentation - The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).

Audit evidence - Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. (See *Sufficiency of audit evidence* and *Appropriateness of audit evidence*.)

Audit file - One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Audit firm - (see *Firm*)

Audit opinion - (see *Modified opinion* and *Unmodified opinion*)

Audit risk - The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Audit sampling (sampling) - The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Audited financial statements (in the context of SA 810) - Financial statements⁴ audited by the auditor in accordance with SAs, and from which the summary financial statements are derived.

Auditor - “Auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used.

Auditor association with financial information - An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection.

³ Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

⁴ SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,” paragraph 13(f), defines the term “financial statements.”

I.14 Auditing Pronouncements

Auditor's expert - An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

Auditor's point estimate or auditor's range - The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Auditor's range - (see *Auditor's point estimate*)

Block Selection - Block selection involves selection of a block(s) of contiguous items from within the population.

Business risk - A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Capabilities (of management's expert) - Capability relates to the ability of the management's expert to exercise that competence in the circumstances.

Classification assertion - Transactions and events have been recorded in the proper accounts.

Comparative financial statements - Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparative information - The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Competence (of management's expert) - Competence relates to the nature and level of expertise of the management's expert.

Compilation engagement - An engagement in which accounting expertise, as opposed to auditing expertise, is used to collect, classify and summarize financial information.

Complementary user entity controls - Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

Completeness Assertion - All transactions and events that should have been recorded have been recorded.

Completion memorandum - A summary that describes the significant matters identified during the audit and how they were, or that includes cross reference to other relevant supporting audit documentation that provides such information.

Compliance framework - (see *Applicable financial reporting framework* and *General purpose framework*)

Component - An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Component auditor - An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Component management - Management responsible for the preparation of the financial information of a component.

Component materiality - The materiality for a component determined by the group engagement team.

Computer-assisted audit techniques - Applications of auditing procedures using the computer as an audit tool (also known as CAATs).

Control activities - Those policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

Control environment - Includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment is a component of internal control.

Control risk - The risk that a material misstatement that could occur will not be prevented, or detected or corrected, on a timely basis by related internal controls (see *Risk of material misstatement*)

Corresponding figures—Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Corporate governance - (see *Governance*)

Capabilities (of management's expert) - Capability relates the ability of the management's expert to exercise that competence in the circumstances.

Criteria - The benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal or less formal. There can be different criteria for the same subject matter. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment.

Suitable criteria—Exhibit the following characteristics:

- (a) *Relevance*: relevant criteria contribute to conclusions that assist decision-making by the intended users.
- (b) *Completeness*: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
- (c) *Reliability*: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.
- (d) *Neutrality*: neutral criteria contribute to conclusions that are free from bias.
- (e) *Understandability*: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

Cut-off Assertion - Transactions and events have been recorded in the correct accounting period.

Date of approval of the financial statements - The date on which all the statements that comprise the financial statements, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Date of report (in relation to quality control) - The date selected by the practitioner to date the report.

I.16 Auditing Pronouncements

Date of the auditor's report - The date the auditor dates the report on the financial statements in accordance with Revised SA 700.⁵

Date of the financial statements—The date of the end of the latest period covered by the financial statements.

Date the financial statements are issued - The date that the auditor's report and audited financial statements are made available to third parties.

Deficiency in internal control - This exists when:

(a) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or

(b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Detection risk - The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Direct Reporting Engagements - In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".

Documentation of the audit plan - A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

Documentation of the overall audit strategy - A record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Element - (see *Element of a financial statement*)

Element of a financial statement (in the context of SA 805⁶)— An element, account or item of a financial statement.

Emphasis of Matter paragraph - A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Engagement documentation— The record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used). The documentation for a specific engagement is assembled in an engagement file.

Engagement letter - Written terms of an engagement in the form of a letter.

Engagement partner - The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

⁵ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements."

⁶ SA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement."

Engagement quality control review - A process designed to provide an objective evaluation, before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report.

Engagement quality control reviewer- A partner, other person⁷ in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.

Engagement team - All personnel performing the engagement, including any experts contracted by the firm in connection with that engagement.⁸

Entity's risk assessment process - A component of internal control that is the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

Environmental matters - (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);

(b) Consequences of violating environmental laws and regulations;

(c) Consequences of environmental damage done to others or to natural resources; and

(d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).

Environmental performance report - A report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

Environmental risk - In certain circumstances, factors relevant to the assessment of inherent risk for the development of the overall audit plan may include the risk of material misstatement of the financial statements due to environmental matters.

Error - An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Estimation uncertainty - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Evaluate - Identify and analyze the relevant issues, including performing further procedures as necessary, to come to a specific conclusion on a matter. "Evaluation," by convention, is used only in relation to a range of matters, including evidence, the results of procedures and the effectiveness of management's response to a risk. (also see Assess)

Exception - A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

Existence Assertion - Assets, liabilities, and equity interests exist.

⁷ Such other person should be a member of the Institute of Chartered Accountants of India.

⁸ SA 620, "Using the Work of an Auditor's Expert," paragraph 6(a), defines the term "auditor's expert".

I.18 Auditing Pronouncements

Experienced auditor - An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

- (a) Audit processes;
- (b) SAs and applicable legal and regulatory requirements;
- (c) The business environment in which the entity operates; and
- (d) Auditing and financial reporting issues relevant to the entity's industry.

Expert - (see *Auditor's expert* and *Management's expert*)

Expertise - Skills, knowledge and experience in a particular field.

Extent of Audit Procedure - Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

External confirmation - Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

Fair presentation framework - (see *Applicable financial reporting framework* and *General purpose framework*)

Financial Reporting Standards - Means the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

Financial statements - A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but it can also refer to a single financial statement.

Firm - A sole practitioner/proprietor, partnership or any such entity of professional accountants, as may be permitted by law.

Forecast - Prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

Fraud - An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud risk factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraudulent financial reporting - Involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

General IT-controls - Policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT-controls commonly include controls over data center and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance.

General purpose financial statements - Financial statements prepared in accordance with a general purpose framework.

General purpose framework - A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.⁹

Governance - Describes the role of person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Group - All the components whose financial information is included in the group financial statements. A group always has more than one component.

Group audit - The audit of group financial statements.

Group audit opinion - The audit opinion on the group financial statements.

Group engagement partner - The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor’s report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.

Group engagement team - Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group financial statements - Financial statements that include the financial information of more than one component. The term “group financial statements” also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

Group management - Management responsible for the preparation of the group financial statements.

Group-wide controls - Controls designed, implemented and maintained by group management over group financial reporting.

Haphazard Selection - Haphazard selection is a sample selection method in which the auditor selects the sample without following a structured technique.

Historical financial information - Information expressed in financial terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Inconsistency - Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor’s opinion on the financial statements.

⁹ SA 200, paragraph 13(a).

I.20 Auditing Pronouncements

Independence - Comprises:

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

Information system relevant to financial reporting - A component of internal control that includes the financial reporting system, and consists of the procedures and records designed and established to

- Initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

Inherent risk - (see *Risk of material misstatement*)

Initial audit engagement - An engagement in which either:

- (a) The financial statements for the prior period were not audited; or
- (b) The financial statements for the prior period were audited by a predecessor auditor.

Inquiry - Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

Inspection (as an audit procedure) - Examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

Inspection (in relation to quality control) - In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

Intended users - The person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

Interim financial information or statements - Financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

Internal audit function - An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.

Internal auditors - Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

Internal control - The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

International Financial Reporting Standards - The International Financial Reporting Standards issued by the International Accounting Standards Board.

Investigate - Inquire into matters arising from other procedures to resolve them.

IT environment - The policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, etc.) and application software that it uses to support business operations and achieve business strategies.

Limited assurance engagement - (see *Assurance engagement*)

Listed entity - An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.

Material Weakness - A weakness in internal control that could have a material effect on the financial statements.

Management - The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

Management bias - A lack of neutrality by management in the preparation and presentation of information.

Management's expert - An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Management's point estimate - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate

Misappropriation of assets - Involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

Misstatement - A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Misstatement of fact - Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Modified opinion - A qualified opinion, an adverse opinion or a disclaimer of opinion.

Monitoring (in relation to quality control) - A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed

I.22 Auditing Pronouncements

engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

Monitoring of controls - A process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary remedial actions modified for changes in conditions. Monitoring of controls is a component of internal control.

Monetary Unit Sampling - Monetary Unit Sampling is a type of value-weighted sample selection method in which sample size, selection and evaluation results in a conclusion in monetary amounts.

Nature of Audit Procedure - The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedures) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure).

Negative confirmation request - A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Network - A larger structure:

- (a) That is aimed at cooperation, and
- (b) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

Network firm - A firm or entity that belongs to a network.

Non-compliance (in the context of SA 250¹⁰) - Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Non-response - A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Non-sampling risk - The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Objectivity (of management's expert) - Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert.

Observation - Consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Occurrence Assertion - Transactions and events that have been recorded have occurred and pertain to the entity.

Opening balances - Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

¹⁰ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

Other information - Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation, or custom, in a document containing audited financial statements and the auditor's report thereon.

Other Matter paragraph - A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Outcome of an accounting estimate - The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Outcome of the evaluation or measurement of a subject matter - The information that results from applying the criteria to the subject matter.

Overall audit strategy - Sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Partner - Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

Performance materiality - The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Personnel - Partners and staff.

Pervasive - A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- (a) Are not confined to specific elements, accounts or items of the financial statements;
- (b) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (c) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Population - The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Positive confirmation request - A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Practitioner - A professional accountant in public practice.

Practitioner's Association with Subject Matter - A practitioner is associated with a subject matter when the practitioner reports on information about the subject matter or consents to the use of the practitioner's name in a professional connection with that subject matter.

Preconditions for an audit - The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise¹¹ on which an audit is conducted.

¹¹ SA 200, paragraph 13(j).

I.24 Auditing Pronouncements

Predecessor auditor - The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted - That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:

- (a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- (b) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide the auditor with:
 - (i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records,
 - (ii) documentation and other matters;
 - (iii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and
 - (iv) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, (a) above may be restated as “for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework,” or “for the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework.”

The “premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted” may also be referred to as the “premise.”

Professional accountant - Member of the Institute of Chartered Accountants of India.

Professional accountant in public practice - Refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

Professional judgment - The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional skepticism - An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

Professional standards - Engagement Standards as defined in the AASB’s “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, and relevant ethical requirements as contained in the Code.

Projection - Prospective financial information prepared on the basis of:

- (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

(b) A mixture of best-estimate and hypothetical assumptions.

Prospective financial information - Financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (See *Forecast* and *Projection*)

Public sector - National governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises).

Random Selection - It is a sample selection method involving application of random number generators, for example, random number tables.

Reasonable assurance (in the context of assurance engagements, including audit engagements, and quality control) - A high, but not absolute, level of assurance.

Reasonable assurance engagement - (see *Assurance engagement*)

Recalculation - Consists of checking the mathematical accuracy of documents or records.

Related party - A party that is either:

- (a) A related party as defined in the applicable financial reporting framework; or
- (b) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - (i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - (iii) Another entity that is under common control with the reporting entity through having:
 - a. Common controlling ownership;
 - b. Owners who are close family members; or
 - c. Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Related services - Comprise agreed-upon procedures and compilations.

Relevant ethical requirements - Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Code of Ethics issued by Institute of Chartered Accountants of India (ICAI) together with other relevant pronouncements issued by the Institute.

Reperformance - The auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal controls.

Report on the description and design of controls at a service organization (referred to in SA 402¹² (Revised) as a Type 1 report) - A report that comprises:

¹² SA 402, "Audit Considerations Relating to an Entity Using a Service Organization".

I.26 Auditing Pronouncements

- (a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and
- (b) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organization's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

Report on the description, design, and operating effectiveness of controls at a service organization (referred to in SA 402) as a Type 2 report) - A report that comprises:

- (a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
- (b) A report by the service auditor with the objective of conveying reasonable assurance that includes:
 - (i) The service auditor's opinion on the description of the service organization's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
 - (ii) A description of the service auditor's tests of the controls and the results thereof.

Responsible party - The person (or persons) who:

- (a) In a direct reporting engagement, is responsible for the subject matter; or
- (b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

Review (in relation to quality control) - Appraising the quality of the work performed and conclusions reached by others.

Review engagement - The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

Review procedures - The procedures deemed necessary to meet the objective of a review engagement, primarily inquiries of entity personnel and analytical procedures applied to financial data.

Rights and Obligations Assertion - The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

Risk assessment procedures - The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Risk of material misstatement - The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

- (a) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- (b) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with

other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Sampling - (see *Audit sampling*)

Sampling risk - The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (a) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (b) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Sampling unit - The individual items constituting a population.

Scope of a review - The review procedures deemed necessary in the circumstances to achieve the objective of the review.

Service auditor - An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.

Service organization - A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

Service organization's system - The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor's report.

Significance - The relative importance of a matter, taken in context. The significance of a matter is judged by the practitioner in the context in which it is being considered. This might include, for example, the reasonable prospect of its changing or influencing the decisions of intended users of the practitioner's report; or, as another example, where the context is a judgment about whether to report a matter to those charged with governance, whether the matter would be regarded as important by them in relation to their duties. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients

Significant component - A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Significant deficiency in internal control - A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Significant risk - An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Single financial statement (for example, a cash flow statement) or to a specific element of a financial statement (for example, cash and bank balances) - Includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

I.28 Auditing Pronouncements

Smaller entity - An entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;
 - (ii) Simple record-keeping;
 - (iii) Few lines of business and few products within business lines;
 - (iv) Few internal controls;
 - (v) Few levels of management with responsibility for a broad range of controls; or
 - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

Special purpose financial statements - Financial statements prepared in accordance with a special purpose framework.

Special purpose framework - A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.¹³

Staff - Professionals, other than partners, including any experts the firm employs.

Statistical sampling - An approach to sampling that has the following characteristics:

- (a) Random selection of the sample items; and
- (b) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

Stratification - The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Subject matter information - The outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

Subsequent events - Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Subservice organization - A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

Substantive procedure - An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (a) Tests of details (of classes of transactions, account balances, and disclosures); and
- (b) Substantive analytical procedures.

¹³ SA 200, paragraph 13(a).

Sufficiency (of audit evidence) - The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Suitable criteria - (see *Criteria*)

Suitably qualified external person - An individual outside the firm with the competence and capabilities to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of another firm.

Summary financial statements (in the context of ISA 810) - Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.¹⁴ Different jurisdictions may use different terminology to describe such historical financial information.

Supplementary information - Information that is presented together with the financial statements that is not required by the applicable financial reporting framework used to prepare the financial statements, normally presented in either supplementary schedules or as additional notes.

Systematic Selection - Systematic selection is a sample selection method, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

Test - The application of procedures to some or all items in a population.

Tests of controls - An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Those charged with governance - The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.¹⁵

Timing of Audit Procedure - Timing of an audit procedure refers to when it is performed, or the period to date to which the audit evidence applies.

Tolerable misstatement - A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Total rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Uncertainty - A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Uncorrected misstatements - Misstatements that the auditor has accumulated during the audit and that have not been corrected.

¹⁴ SA 200, paragraph 13(f).

¹⁵ For discussion of the diversity of governance structures, see paragraphs A1-A8 of SA 260, "Communication with Those Charged with Governance."

I.30 Auditing Pronouncements

Unmodified opinion - The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.¹⁶

User auditor - An auditor who audits and reports on the financial statements of a user entity.

User entity - An entity that uses a service organization and whose financial statements are being audited.

Valuation and Allocation Assertion - Assets, liabilities and equity interest are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Walk-through test - Involves tracing a few transactions through the financial reporting system.

Written representation - A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

¹⁶ SA 700 (Revised), paragraphs 35-36, deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

Standard on Quality Control (SQC) 1

Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*

(Effective for all engagements relating to accounting periods beginning on or after April 1, 2009)

Introduction

1. The purpose of this Standard on Quality Control (SQC) is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This SQC is to be read in conjunction with the requirements of the Chartered Accountants Act, 1949, the Code of Ethics and other relevant pronouncements of the Institute¹ (hereinafter referred to as "the Code").

2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the Auditing and Assurance Standards Board (AASB) issued under the authority of the Council. For example, Standard on Auditing (SA) 220, "Quality Control for an Audit of Financial Statements", establishes standards and provides guidance on quality control procedures for audits of historical financial information.

3. The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm² or engagement partner(s) are appropriate in the circumstances.

4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.

5. This SQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this SQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

Definitions

6. In this SQC, the following terms have the meanings attributed below:

- (a) *Engagement documentation* – the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are also sometimes used). The documentation for a specific engagement is assembled in an engagement file;
- (b) *Engagement partner* – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (c) *Engagement quality control review* – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

* Published in October, 2007 issue of the Journal.

¹ Attention of the members is invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the Committee on Ethical Standards.

² It is clarified that in India the reports are not issued/signed in the firm's name, rather they are issued/signed on behalf of the firm by the sole practitioner, proprietor or a partner of the firm, as the case may be, in his individual name. The definition of a 'firm' has been given in paragraph 6(f) of this Standard.

I.32 Auditing Pronouncements

- (d) *Engagement quality control reviewer* – a partner, other person³ in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
- (e) *Engagement team* – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
- (f) *Firm* – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.
- (g) *Inspection* – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm’s quality control policies and procedures.
- (h) *Listed entity* – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.
- (i) *Monitoring* – a process comprising an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.
- (j) *Network firm*– A firm or entity that belongs to a network.
- (k) *Network* – A larger structure:
 - (i) That is aimed at cooperation, and
 - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (l) *Partner* – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (m) *Personnel* – partners and staff.
- (n) *Professional standards* – engagement standards, as defined in the AASB’s “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” and relevant ethical requirements as contained in the Code.
- (o) *Reasonable assurance* – in the context of this SQC, a high, but not absolute, level of assurance.
- (p) *Staff* – professionals, other than partners, including any experts which the firm employs.
- (q) *Suitably qualified external person* – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee⁴ (with appropriate experience) of another firm.

Elements of a System of Quality Control

7. The firm’s system of quality control should include policies and procedures addressing each of the following elements:

³ Such other person should be a member of the Institute of Chartered Accountants of India.

⁴ Such employee should be a member of the Institute of Chartered Accountants of India.

- (a) Leadership responsibilities for quality within the firm.
- (b) Ethical requirements.
- (c) Acceptance and continuance of client relationships and specific engagements.
- (d) Human resources.
- (e) Engagement performance.
- (f) Monitoring.

8. **The quality control policies and procedures should be documented and communicated to the firm's personnel.** Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Leadership Responsibilities for Quality within the Firm

9. **The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.**

10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality control policies and procedures, and the requirement to:

- (a) Perform work that complies with professional standards and regulatory and legal requirements; and
- (b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:

- (a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;
- (b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and
- (c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

12. **Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.**

I.34 Auditing Pronouncements

13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

14. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

15. Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements are contained in the Code. The Code establishes the fundamental principles of professional ethics, which include:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

16. The Code includes a conceptual approach to independence for assurance engagements, including aspects such as threats to independence, accepted safeguards and the public interest.

17. The firm's policies and procedures should emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring, and (d) a process for dealing with non-compliance. Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

Independence

18. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code. Such policies and procedures should enable the firm to:

- (a) **Communicate its independence requirements to its personnel and, where applicable, to others subject to them; and**
- (b) **Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.**

19. Such policies and procedures should require:

- (a) **Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;**
- (b) **Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and**
- (c) **The accumulation and communication of relevant information to appropriate personnel so that:**
 - (i) **The firm and its personnel can readily determine whether they satisfy independence requirements;**
 - (ii) **The firm can maintain and update its records relating to independence; and**

(iii) The firm can take appropriate action regarding identified threats to independence.

20. The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

- (a) All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;
- (b) The firm to promptly communicate identified breaches of these policies and procedures to:
 - (i) The engagement partner who, with the firm, needs to address the breach; and
 - (ii) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and
- (c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations are contained in the Code.

22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm, as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

23. At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. **Accordingly, the firm should establish policies and procedures:**

- (a) **Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and**
- (b) **For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.**

26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. Therefore, the firm should establish criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as (a) the nature of the engagement, including the extent to which it involves a matter of public interest, and (b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

27. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. **For these audits, the engagement partner should be rotated after a pre-defined period, normally not more than seven years⁵.**

Acceptance and Continuance of Client Relationships and Specific Engagements

28. **The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it:**

- (a) **Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;**
- (b) **Is competent to perform the engagement and has the capabilities, time and resources to do so; and**
- (c) **Can comply with the ethical requirements.**

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

29. With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

30. Information on such matters that the firm obtains may come from, for example:

- Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code, and discussions with other third parties.
- Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
- Background searches of relevant databases.

⁵ The provision of rotation of partners shall not be applicable in case the audit of listed entities is being done by a sole practitioner/proprietor. However, in order to ensure that appropriate system of quality control exists in the firm and that appropriate reports are issued in the circumstances by sole practitioners/proprietors, such practice unit(s) shall be compulsorily reviewed under the process of peer review. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm would be able to complete the engagement within the reporting deadline.

32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of interest⁶. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.

33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.

34. Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

- (a) **The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and**
- (b) **The possibility of withdrawing from the engagement or from both the engagement and the client relationship.**

35. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

⁶ Attention of the members is invited to the 'Code of Ethics' and the 'Guidance Note on Independence of Auditors' issued by the ICAI.

Human Resources

36. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

37. Such policies and procedures address the following personnel issues:

- (a) Recruitment;
- (b) Performance evaluation;
- (c) Capabilities;
- (d) Competence;
- (e) Career development;
- (f) Promotion;
- (g) Compensation; and
- (h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Coaching by more experienced staff, for example, other members of the engagement team.

39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain and also enhance their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures, the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.

40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:

- (a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;
- (b) Provides personnel with evaluation of, and counseling on, performance, progress and career development; and
- (c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Assignment of Engagement Teams

42. The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:

- (a) **The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;**
- (b) **The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and**
- (c) **The responsibilities of the engagement partner are clearly defined and communicated to that partner.**

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

44. The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning engagement teams, and in determining the level of supervision required, include the following:

- An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- An understanding of professional standards and regulatory and legal requirements.
- Appropriate technical knowledge, including knowledge of relevant information technology.
- Knowledge of the relevant industries in which the clients operate.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

Engagement Performance

46. The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.

I.40 Auditing Pronouncements

- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

49. Supervision includes the following:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.
- Addressing significant issues arising during the engagement, considering their significance and appropriately modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

- (a) The work has been performed in accordance with professional standards and regulatory and legal requirements;
- (b) Significant matters have been raised for further consideration;
- (c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- (d) There is a need to revise the nature, timing and extent of work performed;
- (e) The work performed supports the conclusions reached and is appropriately documented;
- (f) The evidence obtained is sufficient and appropriate to support the report; and
- (g) The objectives of the engagement procedures have been achieved.

Consultation

51. The firm should establish policies and procedures designed to provide it with reasonable assurance that:

- (a) Appropriate consultation takes place on difficult or contentious matters;**
- (b) Sufficient resources are available to enable appropriate consultation to take place;**
- (c) The nature and scope of such consultations are documented; and**
- (d) Conclusions resulting from consultations are documented and implemented.**

52. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

53. Consultation uses appropriate research resources as well as the collective experience and technical

expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. The firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.

55. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by (a) other firms, or (b) professional and regulatory bodies. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

- (a) The issue on which consultation was sought; and
- (b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

57. The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.

58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. **The report should not be issued until the matter is resolved.**

59. A firm using a suitably qualified external person(s) to conduct an engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

60. The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:

- (a) **Require an engagement quality control review for all audits of financial statements of listed entities;**
- (b) **Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and**
- (c) **Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).**

61. The firm's policies and procedures should require the completion of the engagement quality

I.42 Auditing Pronouncements

control review before the report is issued.

62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

63. The firm should establish policies and procedures setting out:

- (a) The nature, timing and extent of an engagement quality control review;**
- (b) Criteria for the eligibility of engagement quality control reviewers; and**
- (c) Documentation requirements for an engagement quality control review.**

Nature, Timing and Extent of the Engagement Quality Control Review

64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments that the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

65. An engagement quality control review for audits of financial statements of listed entities includes considering the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
- The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Criteria for the Eligibility of Engagement Quality Control Reviewers

68. The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:

- (a) **The technical qualifications required to perform the role, including the necessary experience and authority; and**
- (b) **The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.**

69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

- (a) Is not selected by the engagement partner;
- (b) Does not otherwise participate in the engagement during the period of review;
- (c) Does not make decisions for the engagement team; and
- (d) Is not subject to other considerations that would threaten the reviewer's objectivity.

71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 69-72.

Documentation of the Engagement Quality Control Review

73. Policies and procedures on documentation of the engagement quality control review should require documentation that:

- (a) **The procedures required by the firm's policies on engagement quality control review have been performed;**
- (b) **The engagement quality control review has been completed before the report is issued; and**
- (c) **The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.**

Engagement Documentation

Completion of the Assembly of Final Engagement Files

74. The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.

75. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation, the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

76. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

77. The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

78. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

79. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for engagement documentation to:

- (a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;
- (b) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties *via* the Internet;
- (c) Prevent unauthorized changes to the engagement documentation; and
- (d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

80. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of

engagement, processing it during engagement, and collating it at the end of engagement.

- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.
81. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:
- (a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
 - (b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and
 - (c) Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

Retention of Engagement Documentation

82. The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.

83. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years⁷ from the date of the auditor's report, or, if later, the date of the group auditor's report.

84. Procedures that the firm adopts for retention of engagement documentation include those that:
- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
 - Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
 - Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Ownership of Engagement Documentation

85. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm.

⁷ The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, 'Audit Documentation', issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

I.46 Auditing Pronouncements

The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

86. The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

87. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- (a) Adherence to professional standards and regulatory and legal requirements;
- (b) Whether the quality control system has been appropriately designed and effectively implemented; and
- (c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

88. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.

89. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

- Analysis of:
 - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
 - Written confirmation of compliance with policies and procedures on independence;
 - Continuing professional development, including training; and
 - Decisions related to acceptance and continuance of client relationships and specific engagements.
- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

90. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.

- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

91. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

92. Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

93. The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:

- (a) **Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or**
- (b) **Systemic, repetitive or other significant deficiencies that require prompt corrective action.**

94. The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

95. The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

- (a) **Taking appropriate remedial action in relation to an individual engagement or member of personnel;**
- (b) **The communication of the findings to those responsible for training and professional development;**
- (c) **Changes to the quality control policies and procedures; and**
- (d) **Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.**

96. Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.

97. At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing partner(s). Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should

include the following:

- (a) **A description of the monitoring procedures performed.**
- (b) **The conclusions drawn from the monitoring procedures.**
- (c) **Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.**

98. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

99. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this SQC, and these firms place reliance on such a monitoring system:

- (a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;
- (b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and
- (c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

100. Appropriate documentation relating to monitoring:

- (a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;
- (b) Records the evaluation of:
 - (i) Adherence to professional standards and regulatory and legal requirements;
 - (ii) Whether the quality control system has been appropriately designed and effectively implemented; and
 - (iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and
- (c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

Complaints and Allegations

101. The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

- (a) **Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and**
- (b) **Allegations of non-compliance with the firm's system of quality control.**

102. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

103. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

104. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

105. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 95.

Documentation

106. The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.

107. How such matters are documented is the firm's decision. For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more simpler and informal methods such as manual notes, checklists and forms.

108. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:

- The size of the firm and the number of offices.
- The degree of authority both personnel and offices have.
- The nature and complexity of the firm's practice and organization.

109. The firm retains this documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

110. This Standard on Quality Control is recommendatory for all engagements relating to accounting periods beginning on or after April 1, 2008 and is mandatory for all engagements relating to accounting periods beginning on or after April 1, 2009.

Material Modifications to the International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"

Additions

1. Paragraph 6(d) of the ISQC 1, dealing with the definition of "engagement quality control reviewer" mentions that "other person in the firm" with sufficient and appropriate experience and authority can also act as quality control reviewer. The SQC 1 has retained this concept subject to the condition that such "other person in the firm" should also be a member of the Institute of Chartered Accountants of India.

2. Paragraph 6(d) of the ISQC 1, while defining the "engagement quality control reviewer" provides that the review can be done by a team of individuals comprising the partner, other person in the firm and/or the suitably qualified external person. The SQC 1 has retained this concept subject to the condition that in case of review by a team of individuals, such team should be headed by a member of the Institute.

I.50 Auditing Pronouncements

3. Paragraph 6(f) of the ISQC 1 defines “firm” as “a sole practitioner, partnership, corporation or other entity of professional accountants”. Since in India an individual can practice in his individual name and also in the name of the firm as proprietor of that firm, accordingly, the term ‘Proprietor’ has been added to the definition of the firm.

4. Paragraph 83 of the ISQC 1 prescribes the minimum period of engagement documentation as five years. The SQC 1 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, including regulations therein, prescribes the minimum period of retention of working papers as seven years.

Deletions

1. Paragraph 6(f) of the ISQC 1 defines “firm” as “a sole practitioner, partnership, corporation or other entity of professional accountants”. Since in India, the practitioners establish any corporate entity for practice, the word ‘Corporation’ has been deleted from the definition.

2. In terms of paragraph 6(p) of the ISQC 1, defining a “suitably qualified external person” as a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organisation that provides relevant quality control services. Since, in India only the Institute of Chartered Accountants of India is the professional body whose members can carry out an audit or a review of historical financial information or other assurance engagement, a specific reference to this fact appearing in the context of “partner of another firm or an employee” has been deleted from the definition of “suitably qualified external person”.

3. Paragraph 6(p) lays down that “an organisation that provides relevant quality control services” can also act as a suitably qualified person. The SQC does not include any such requirement since it is felt that a review of a firm of accountants should be done by a similar firm of accountants only.

4. Paragraph 27 of the ISQC 1 requires that in all engagements of audit of listed companies, the engagement partner of the firm should be rotated within a period of seven years in order to avoid the familiarity threat. The SQC 1 does not mandate such a provision in the audit engagements of the listed entities that are audited by the sole practitioners/proprietors as it is not possible to apply the provision in such cases. However, the SQC 1 provides for peer review of those firms in order to mitigate familiarity threat.

5. The ISQC 1 also deals with the public sector perspective. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Standard does not specifically mention that aspect.

Framework for Assurance Engagements*

(Effective From April 1, 2008)

Introduction

1. This Framework defines and describes the elements and objectives of an assurance engagement, and identifies engagements to which Standards on Auditing (SAs), Standards on Review Engagements (SREs) and Standards on Assurance Engagements (SAEs) apply. It provides a frame of reference for:

- (a) Professional accountants in public practice¹ (practitioners) when performing assurance engagements. Professional accountants who are neither in public practice nor in the public sector are encouraged to consider the Framework when performing assurance engagements²
- (b) Others involved with assurance engagements, including the intended users of an assurance report and the responsible party; and
- (c) The Auditing and Assurance Standards Board (AASB) in its development of SAs, SREs and SAEs.

This Framework does not cover engagements covered by Standards on Related Services (SRSs), such as engagements to perform agreed-upon procedures and engagements to compile financial or other information since the members do not express any assurance on the financial information or any other subject matter of their report.

2. This Framework does not itself establish standards or provide procedural requirements for the performance of assurance engagements. SAs, SREs and SAEs contain basic principles, essential procedures and related guidance, consistent with the concepts in this Framework, for the performance of assurance engagements.

3. The following is an overview of this Framework:

- *Introduction:* This Framework deals with assurance engagements performed by practitioners. It provides a frame of reference for practitioners and others involved with assurance engagements, such as those engaging a practitioner (the “engaging party”).
- *Definition and objective of an assurance engagement:* This section defines assurance engagements and identifies the objectives of the two types of assurance engagements a practitioner is permitted to perform. This Framework calls these two types reasonable assurance engagements and limited assurance engagements.³
- *Scope of the Framework:* This section distinguishes assurance engagements from other engagements, such as consulting engagements.

* Published in July, 2007 issue of the Journal.

¹ As defined in the Preface, the term “professional accountant” refers to the member of the Institute of Chartered Accountants of India. Further, the term “professional accountant in public practice (practitioner)” refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

² If a professional accountant not in public practice applies this Framework, and (a) this Framework, the SAs, SREs or the SAEs are referred to in the professional accountant’s report; and (b) the professional accountant or other members of the assurance team and, when applicable, the professional accountant’s employer, are not independent of the entity in respect of which the assurance engagement is being performed, the lack of independence and the nature of the relationship(s) with the entity are prominently disclosed in the professional accountant’s report. Also, that report does not include the word “independent” in its title, and the purpose and users of the report are restricted.

³ For assurance engagements relating to historical financial information in particular, such engagements which provide reasonable assurance are called audits, and those engagements which provide limited assurance are called reviews.

I.52 Auditing Pronouncements

- *Engagement acceptance*: This section sets out characteristics that must be exhibited before a practitioner can accept an assurance engagement.
- *Elements of an assurance engagement*: This section identifies and discusses five elements that assurance engagement performed by practitioners exhibit: a three party relationship, a subject matter, criteria, evidence and an assurance report. It explains important distinctions between reasonable assurance engagements and limited assurance engagements (also outlined in **Appendix** to the Framework). This section also discusses, for example, the significant variation in the subject matters of assurance engagements, the required characteristics of suitable criteria, the role of risk and materiality in assurance engagements, and how conclusions are expressed in each of the two types of assurance engagements.
- *Inappropriate use of the practitioner's name*: This section discusses implications of a practitioner's association with a subject matter.

Ethical Principles and Quality Control Standards

4. In addition to this Framework and SAs, SREs and SAEs, practitioners who perform assurance engagements are governed by:

- (a) The requirements of the Chartered Accountants Act, 1949;
- (b) The Code of Ethics (the Code), issued by the Institute, which establishes fundamental ethical principles for professional accountants;
- (c) Other relevant pronouncements of the Institute of Chartered Accountants of India⁴; and
- (d) Standards on Quality Control (SQC)s, which establish standards and provide guidance on a firm's system of quality control⁵.

5. The Code of Ethics sets out the fundamental ethical principles that all professional accountants are required to observe, including:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behaviour.

Definition and Objective of an Assurance Engagement

6. "Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

7. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:

- The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement,

⁴ Attention of the members is invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the Institute of Chartered Accountants of India.

⁵ Additional Standards and guidance on quality control procedures for specific types of assurance engagements are set out in SAs, SREs and SAEs.

presentation and disclosure, such as the Accounting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).

- An assertion about the effectiveness of internal control (outcome) results from applying a framework for evaluating the effectiveness of internal control, (criteria) to internal control, a process (subject matter).

In the remainder of this Framework, the term "subject matter information" will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

8. Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be misstated, potentially to a material extent. This occurs when the subject matter information does not properly reflect the application of the criteria to the subject matter, for example, when an entity's financial statements do not give a true and fair view of (or present fairly, in all material respects) its financial position, financial performance and cash flows in accordance with the generally accepted accounting principles, or when an entity's assertion that its internal control is effective is not fairly stated, in all material respects, based on the established internal control framework.

9. In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements". In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".

10. Under this Framework, there are two types of assurance engagements a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement⁶ as the basis for a positive form of expression of the practitioner's conclusion. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Scope of the Framework

11. Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements that do not meet the above definition (and therefore are not covered by this Framework) include:

- Engagements covered by Standards for Related Services, such as agreed-upon procedures engagements and compilations of financial or other information.
- The preparation of tax returns where no conclusion conveying assurance is expressed.

⁶ Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

I.54 Auditing Pronouncements

➤ Consulting (or advisory) engagements⁷, such as management and tax consulting.

12. An assurance engagement may be part of a larger engagement, for example, when a business acquisition consulting engagement includes a requirement to convey assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.

13. The following engagements, which may meet the definition in paragraph 6, need not be performed in accordance with this Framework:

- (a) Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters; and
- (b) Engagements that include professional opinions, views or wording from which a user may derive some assurance, if all of the following apply:
 - (i) Those opinions, views or wording are merely incidental to the overall engagement;
 - (ii) Any written report issued is expressly restricted for use by only the intended users specified in the report;
 - (iii) Under a written understanding with the specified intended users, the engagement is not intended to be an assurance engagement; and
 - (iv) The engagement is not represented as an assurance engagement in the professional accountant's report.

Reports on Non-Assurance Engagements

14. A practitioner reporting on an engagement that is not an assurance engagement within the scope of this Framework, clearly distinguishes that report from an assurance report. So as not to confuse users, a report that is not an assurance report avoids, for example:

- Implying compliance with this Framework, SAs, SREs or SAEs.
- Inappropriately using the words “assurance,” “audit” or “review.”
- Including a statement that could reasonably be mistaken for a conclusion designed to enhance the degree of confidence of intended users about the outcome of the evaluation or measurement of a subject matter against criteria.

15. The practitioner and the responsible party may agree to apply the principles of this Framework to an engagement when there are no intended users other than the responsible party but where all other requirements of the SAs, SREs or SAEs are met. In such cases, the practitioner's report includes a statement restricting the use of the report to the responsible party.

Engagement Acceptance

16. A practitioner accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

⁷ Consulting engagements employ a professional accountant's technical skills, education, observations, experiences and knowledge of the consulting process. The consulting process is an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results and sometimes implementation and follow-up. Reports (if issued) are generally written in a narrative (or “long form”) style. Generally the work performed is only for the use and benefit of the client. The nature and scope of work is determined by agreement between the professional accountant and the client. Any service that meets the definition of an assurance engagement is not a consulting engagement but an assurance engagement.

- (a) Relevant ethical requirements, such as independence and professional competence will be satisfied, and
- (b) The engagement exhibits all of the following characteristics:
 - (i) The subject matter is appropriate;
 - (ii) The criteria to be used are suitable and are available to the intended users;
 - (iii) The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;
 - (iv) The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
 - (v) The practitioner is satisfied that there is a rational purpose for the engagement. If there is a significant limitation on the scope of the practitioner's work (see paragraph 54), it may be unlikely that the engagement has a rational purpose. Also, a practitioner may believe the engaging party intends to associate the practitioner's name with the subject matter in an inappropriate manner (see paragraph 60).

Specific SAs, SREs or SAEs may include additional requirements that need to be satisfied prior to accepting an engagement.

17. When a potential engagement cannot be accepted as an assurance engagement because it does not exhibit all the characteristics in the previous paragraph, the engaging party may be able to identify a different engagement that will meet the needs of intended users. For example:

- (a) If the original criteria were not suitable, an assurance engagement may still be performed if:
 - (i) the engaging party can identify an aspect of the original subject matter for which those criteria are suitable, and the practitioner could perform an assurance engagement with respect to that aspect as a subject matter in its own right. In such cases, the assurance report makes it clear that it does not relate to the original subject matter in its entirety; or
 - (ii) alternative criteria suitable for the original subject matter can be selected or developed.
- (b) The engaging party may request an engagement that is not an assurance engagement, such as a consulting or an agreed-upon procedures engagement.

18. Having accepted an assurance engagement, a practitioner may not change that engagement to a non-assurance engagement, or from a reasonable assurance engagement to a limited assurance engagement without reasonable justification. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

Elements of an Assurance Engagement

19. The following elements of an assurance engagement are discussed in this section:
- (a) A three party relationship involving a practitioner, a responsible party, and intended users;
 - (b) An appropriate subject matter;
 - (c) Suitable criteria;
 - (d) Sufficient appropriate evidence; and
 - (e) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

Three Party Relationship

20. Assurance engagements involve three separate parties: a practitioner, a responsible party and intended users.

21. The responsible party and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the management board of that entity. The relationship between the responsible party and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the responsible party), but for which senior management is ultimately responsible.

Practitioner

22. The term "practitioner" as used in this Framework is broader than the term "auditor" as used in SAs and SREs, which relates only to practitioners performing audit or review engagements with respect to historical financial information.

23. A practitioner may be requested to perform assurance engagements on a wide range of subject matters. Some subject matters may require specialized skills and knowledge beyond those ordinarily possessed by an individual practitioner. As noted in paragraph 17 (a), a practitioner does not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases this requirement can be satisfied by the practitioner using the work of persons from other professional disciplines, referred to as experts. In such cases, the practitioner is satisfied that those persons carrying out the engagement collectively possess the requisite skills and knowledge, and that the practitioner has an adequate level of involvement in the engagement and understanding of the work for which any expert is used.

Responsible Party

24. The responsible party is the person (or persons) who:

- (a) in a direct reporting engagement, is responsible for the subject matter; or
- (b) in an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the responsible party is responsible for both the subject matter information and the subject matter, is when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is responsible for the subject matter information but not the subject matter, is when a government organization engages a practitioner to perform an assurance engagement regarding a report about a private company's sustainability practices that the organization has prepared and is to distribute to intended users.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

25. The responsible party ordinarily provides the practitioner with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting engagement, the practitioner may not be able to obtain such a representation when the engaging party is different from the responsible party.

Intended Users

26. The intended users are the person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

27. Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users. The practitioner may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law.

28. Whenever practical, intended users or their representatives are involved with the practitioner and the responsible party (and the engaging party, if different) in determining the requirements of the engagement. Regardless of the involvement of others however, and unlike an agreed-upon procedures engagement (which involves reporting findings based upon the procedures, rather than a conclusion):

- (a) The practitioner is responsible for determining the nature, timing and extent of procedures; and
- (b) The practitioner is required to pursue any matter the practitioner becomes aware of that leads the practitioner to question whether a material modification should be made to the subject matter information.

29. In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the responsible party (or the engaging party, if different) to arrange for, an assurance engagement to be performed for a specific purpose. When engagements are designed for specified intended users or a specific purpose, the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose.

Subject Matter

30. The subject matter, and subject matter information, of an assurance engagement can take many forms, such as:

- Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
- Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
- Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
- Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
- Behaviour (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

31. Subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:

- (a) precision with which the subject matter can be evaluated or measured against criteria; and
- (b) the persuasiveness of available evidence.

The assurance report notes characteristics of particular relevance to the intended users.

32. An appropriate subject matter is:

I.58 Auditing Pronouncements

- (a) identifiable, and capable of consistent evaluation or measurement against the identified criteria; and
- (b) such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

Criteria

33. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal, for example in the preparation of financial statements, the criteria may be Accounting Standards issued by the Institute; when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the engagement; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).

34. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances. Even for the same subject matter there can be different criteria. For example, one responsible party might select the number of customer complaints resolved to the acknowledged satisfaction of the customer for the subject matter of customer satisfaction; another responsible party might select the number of repeat purchases in the three months following the initial purchase.

35. Suitable criteria exhibit the following characteristics:

- (a) *Relevance*: relevant criteria contribute to conclusions that assist decision-making by the intended users.
- (b) *Completeness*: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
- (c) *Reliability*: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.
- (d) *Neutrality*: neutral criteria contribute to conclusions that are free from bias.
- (e) *Understandability*: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

The evaluation or measurement of a subject matter on the basis of the practitioner's own expectations, judgments and individual experience would not constitute suitable criteria.

36. The practitioner assesses the suitability of criteria for a particular engagement by considering whether they reflect the above characteristics. The relative importance of each characteristic to a particular engagement is a matter of judgment. Criteria can either be established or specifically developed. Established criteria are those embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process. Specifically developed criteria are those designed for the purpose of the engagement. Whether criteria are established or specifically developed affects the work that the practitioner carries out to assess their suitability for a particular engagement.

37. Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. Criteria are made available to the intended users in one or more of the

following ways:

- (a) Publicly.
- (b) Through inclusion in a clear manner in the presentation of the subject matter information.
- (c) Through inclusion in a clear manner in the assurance report.
- (d) By general understanding, for example the criterion for measuring time in hours and minutes.

Criteria may also be available only to specific intended users, for example, the terms of a contract, or criteria issued by an industry association that are available only to those in the industry. When identified criteria are available only to specific intended users, or are relevant only to a specific purpose, use of the assurance report is restricted to those users or for that purpose.⁸

Evidence

38. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. The practitioner considers materiality, assurance engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence-gathering procedures.

Professional Skepticism

39. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism recognizing that circumstances may exist that cause the subject matter information to be materially misstated. An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. For example, an attitude of professional skepticism is necessary throughout the engagement process for the practitioner to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence-gathering procedures and evaluating the results thereof.

40. An assurance engagement rarely involves the authentication of documentation, nor is the practitioner trained as or expected to be an expert in such authentication. However, the practitioner considers the reliability of the information to be used as evidence, for example, photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

Sufficiency and Appropriateness of Evidence

41. Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The quantity of evidence needed is affected by the risk of the subject matter information being materially misstated (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence may not compensate for its poor quality.

42. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of

⁸ While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose, does not itself indicate that a legal responsibility is owed by the practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the circumstances of each case and the relevant jurisdiction.

I.60 Auditing Pronouncements

evidence can be made; however, such generalizations are subject to important exceptions. Even when evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of evidence may be useful:

- Evidence is more reliable when it is obtained from independent sources outside the entity.
- Evidence that is generated internally is more reliable when the related controls are effective.
- Evidence obtained directly by the practitioner (for example, observation of the application of a control) is more reliable than evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Evidence is more reliable when it exists in documentary form, whether paper, electronic, or other media (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of what was discussed).
- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

43. The practitioner ordinarily obtains more assurance from consistent evidence obtained from different sources or of a different nature than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may indicate that an individual item of evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the practitioner obtains from a representation from the responsible party. Conversely, when evidence obtained from one source is inconsistent with that obtained from another, the practitioner determines what additional evidence-gathering procedures are necessary to resolve the inconsistency.

44. In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information covering a period than about subject matter information at a point in time. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; the practitioner provides no conclusion about whether the process will continue to function in the specified manner in the future.

45. The practitioner considers the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

Materiality

46. Materiality is relevant when the practitioner determines the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of misstatement. When considering materiality, the practitioner understands and assesses what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

Assurance Engagement Risk

47. Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated⁹. In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However, in a limited assurance engagement, the combination of the nature, timing and extent of evidence-gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

48. In general, assurance engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:

- (a) The risk that the subject matter information is materially misstated, which in turn consists of:
 - (i) *Inherent risk*: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and
 - (ii) *Control risk*: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and
- (b) *Detection risk*: the risk that the practitioner will not detect a material misstatement that exists.

The degree to which the practitioner considers each of these components is affected by the engagement circumstances, in particular by the nature of the subject matter and whether a reasonable assurance or a limited assurance engagement is being performed.

Nature, Timing and Extent of Evidence-gathering Procedures

49. The exact nature, timing and extent of evidence-gathering procedures will vary from one engagement to the next. In theory, infinite variations in evidence-gathering procedures are possible. In practice, however, these are difficult to communicate clearly and unambiguously. The practitioner attempts to communicate them clearly and unambiguously and uses the form appropriate to a reasonable assurance engagement or a limited assurance engagement.¹⁰

⁹ (a) This includes the risk, in those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, that the practitioner inappropriately concludes that the subject matter does, in all material respects, conform with the criteria, for example: "In our opinion, internal control is effective, in all material respects, based on XYZ criteria".

(b) In addition to assurance engagement risk, the practitioner is exposed to the risk of expressing an inappropriate conclusion when the subject matter information is not materially misstated, and risks through loss from litigation, adverse publicity, or other events arising in connection with a subject matter reported on. These risks are not part of assurance engagement risk.

¹⁰ Where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence-gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable assurance or a limited assurance engagement.

I.62 Auditing Pronouncements

50. "Reasonable assurance" is a concept relating to accumulating evidence necessary for the practitioner to conclude in relation to the subject matter information taken as a whole. To be in a position to express a conclusion in the positive form required in a reasonable assurance engagement, it is necessary for the practitioner to obtain sufficient appropriate evidence as part of an iterative, systematic engagement process involving:

- (a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;
- (b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;
- (c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;
- (d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the responsible party, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and
- (e) Evaluating the sufficiency and appropriateness of evidence.

51. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

52. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. For example, SRE 2400¹¹ (Revised), "Engagements to Review Financial Statements" establishes that sufficient appropriate evidence for reviews of financial statements is obtained primarily through analytical procedures and inquiries. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular, the subject matter,

¹¹ Published in May 2010 issue of the Journal.

and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the practitioner becomes aware of a matter that leads the practitioner to question whether a material modification should be made to the subject matter information, the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.

Quantity and Quality of Available Evidence

53. The quantity or quality of available evidence is affected by:

- (a) The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when information about the subject matter is future-oriented rather than historical (see paragraph 31); and
- (b) Circumstances of the engagement other than the characteristics of the subject matter, when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the practitioner's appointment, an entity's document retention policy, or a restriction imposed by the responsible party.

Ordinarily, available evidence will be persuasive rather than conclusive.

54. An unqualified conclusion is not appropriate for either type of assurance engagement in the case of a material limitation on the scope of the practitioner's work, that is, when:

- (a) Circumstances prevent the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level; or
- (b) The responsible party or the engaging party imposes a restriction that prevents the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level.

Assurance Report

55. The practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. SAs, SREs and SAEs establish basic elements for assurance reports. In addition, the practitioner considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.

56. In an assertion-based engagement, the practitioner's conclusion can be worded either:

- (a) In terms of the responsible party's assertion (for example: "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria*, is fairly stated"); or
- (b) Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*").

In a direct reporting engagement, the practitioner's conclusion is worded directly in terms of the subject matter and the criteria.

57. In a reasonable assurance engagement, the practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*". This form of expression conveys "reasonable assurance". Having performed evidence-gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant engagement circumstances described in the assurance report, the practitioner has obtained

I.64 Auditing Pronouncements

sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level.

58. In a limited assurance engagement, the practitioner expresses the conclusion in the negative form, for example, “based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria”. This form of expression conveys a level of “limited assurance” that is proportional to the level of the practitioner’s evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

59. A practitioner does not express an unqualified conclusion for either type of assurance engagement when the following circumstances exist and, in the practitioner’s judgment, the effect of the matter is or may be material:

- (a) There is a limitation on the scope of the practitioner’s work (see paragraph 54). The practitioner expresses a qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the limitation is. In some cases the practitioner considers withdrawing from the engagement.
- (b) In those cases where:
 - (i) The practitioner’s conclusion is worded in terms of the responsible party’s assertion, and that assertion is not fairly stated, in all material respects; or
 - (ii) The practitioner’s conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated,¹²The practitioner expresses a qualified or adverse conclusion depending on how material or pervasive the matter is.
- (c) When it is discovered after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The practitioner expresses:
 - (i) A qualified conclusion or adverse conclusion depending on how material or pervasive the matter is, when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or
 - (ii) A qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the matter is, in other cases.

In some cases, the practitioner considers withdrawing from the engagement.

Inappropriate Use of the Practitioner’s Name

60. A practitioner is associated with a subject matter when the practitioner reports on information about that subject matter or consents to the use of the practitioner’s name in a professional connection with that subject matter. If the practitioner is not associated in this manner, third parties can assume no responsibility of the practitioner. If the practitioner learns that a party is inappropriately using the practitioner’s name in association with a subject matter, the practitioner requires the party to cease doing so. The practitioner also considers what other steps may be needed, such as informing any known third party users of the inappropriate use of the practitioner’s name or seeking legal advice.

¹² In those direct reporting engagements where the subject matter information is presented only in the practitioner’s conclusion, and the practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: “In our opinion, except for [...], internal control is effective, in all material respects, based on XYZ criteria,” such a conclusion would also be considered to be qualified (or adverse as appropriate).

Material Modifications to International Framework for Assurance Engagements

Deletions

1. The International Framework issued by the IAASB specifically makes it clear that such Framework is also relevant to professional accountants in public sector. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Framework does not specifically mention that aspect.
2. Paragraph 6 of the International Framework issued by the IAASB refers to Part B of the International Code of Ethics regarding threats to independence, accepted safeguards and the public interest, which is applicable to professional accountants in public practice, has been deleted since the Code of Ethics issued by the ICAI is woven around the Chartered Accountants Act, 1949 and Schedules annexed thereto.

Appendix

Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements

This Appendix outlines the differences between a reasonable assurance engagement and a limited assurance engagement discussed in the Framework (see in particular the referenced paragraphs).

Type of Engagement	Objective	Evidence-gathering procedures ¹³	The Assurance Report
Reasonable Assurance Engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion (Paragraph 10)	<ul style="list-style-type: none"> ➤ Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: ➤ Obtaining an understanding of the engagement circumstances; ➤ Assessing risks; ➤ Responding to assessed risks; ➤ Performing further procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and ➤ Evaluating the evidence obtained (Paragraphs 50 and 51) 	Description of the engagement circumstances and a positive form of expression of the conclusion (Paragraph 57)

¹³ A detailed discussion of evidence-gathering requirement is only possible within SAEs for specific subject matters.

I.66 Auditing Pronouncements

Limited Assurance Engagement	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion (Paragraph 10)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to reasonable assurance engagement (Paragraph 52)	Description of the engagement circumstances, and a negative form of expression of the conclusion (Paragraph 58)
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SA 200 *

**Overall Objectives of the Independent Auditor and
the Conduct of an Audit in Accordance with
Standards on Auditing**
*(Effective for all audits relating to accounting periods
beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as "the auditor" hereafter.
2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)
4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)
5. As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an

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inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A28-A52)

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements¹. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13)

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations².

Effective Date

10. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the

¹ SA 320, "Materiality in Planning and Performing an Audit" and SA 450, "Evaluation of Misstatements Identified during the Audit".

² See, for example, SA 260, "Communication with Those Charged with Governance"; and paragraph 43 of SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

auditor's findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

Definitions

13. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

(b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:

- (i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.
- (ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

(c) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

(d) Auditor – "Auditor" is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.

(e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

(f) Financial statements – A structured representation of historical financial information, including related

I.70 Auditing Pronouncements

notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

- (g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- (h) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
- (i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with SAs. That is, responsibility:
 - (i) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - (ii) To provide the auditor with:
 - a. All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - b. Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - c. Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework. This applies to all references to "preparation and presentation of the financial statements" in the SAs.

The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise".

- (k) Professional judgment – The application of relevant training, knowledge and experience, within the

context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

- (l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- (m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.
- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
 - (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
 - (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- (o) Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A14-A17)

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-A22)

Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23-A27)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A28-A52)

Conduct of an Audit in Accordance with SAs

Complying with SAs Relevant to the Audit

18. The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist. (Ref: Para. A53-A56)

19. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A57-A65)

I.72 Auditing Pronouncements

20. The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

Objectives Stated in Individual SAs

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to: (Ref: Para. A66-A68)

- (a) Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and (Ref: Para. A69)
- (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A70)

Complying with Relevant Requirements

22. Subject to paragraph 23, the auditor shall comply with each requirement of an SA unless, in the circumstances of the audit:

- (a) The entire SA is not relevant; or
- (b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

Failure to Achieve an Objective

24. If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230³. (Ref: Para. A74-A75)

Application and Other Explanatory Material

An Audit of Financial Statements

Scope of the Audit (Ref: Para. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

³ SA 230, "Audit Documentation", paragraph 8(c).

Preparation of the Financial Statements (Ref: Para. 4)

A2. An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:

- (a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (b) To provide the auditor with:
 - (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (i.e., “general purpose financial statements”); or
- The financial information needs of specific users (i.e., “special purpose financial statements”).

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
- Published views of varying authority on emerging accounting issues issued by standards setting,

I.74 Auditing Pronouncements

professional or regulatory organisations;

- General and industry practices widely recognised and prevalent; and
- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation.

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; statement of profit and loss; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:

- For example, normally, in government departments and local bodies, the primary financial statement is a statement of cash receipts and payments.
- Other examples of a single financial statement, each of which would include related notes, are:
 - Balance sheet.
 - Statement of profit & loss.
 - Statement of cash flows.
 - Statement of operations by product lines.

A9. SA 210 establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework⁴. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework⁵.

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement⁶. The auditor is also required to obtain written representations about whether

⁴ SA 210, "Agreeing the Terms of Audit Engagements", paragraph 6(a).

⁵ SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 8.

⁶ SA 210, paragraph 6(b).

management and, where appropriate, those charged with governance have fulfilled those responsibilities⁷.

Considerations Specific to Central/State Governments and Related Government Entities

A11. The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Form of the Auditor's Opinion (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India.

A15. The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

⁷ SA 580, "Written Representations", paragraphs 10-11.

I.76 Auditing Pronouncements

A17. Standard on Quality Control (SQC) 1⁸ sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence⁹. SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement¹⁰. SA 220 recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

Professional Skepticism (Ref: Para. 15)

A18. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence¹¹. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and

⁸ Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".

⁹ SQC 1, paragraphs 14-27.

¹⁰ SA 220, "Quality Control for an Audit of Financial Statements", paragraphs 9-12.

¹¹ SA 500, "Audit Evidence", paragraphs 7-9.

determine what modifications or additions to audit procedures are necessary to resolve the matter¹².

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by SA 220¹³, assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit¹⁴. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

¹² SA 240, paragraph 13; SA 500, paragraph 11; and SA 505, paragraphs 10-11, and 16.

¹³ SA 220, paragraph 18.

¹⁴ SA 230, paragraph 8.

Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)

Sufficiency and Appropriateness of Audit Evidence

A28. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit¹⁵) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

A29. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A30. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A31. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 500 and other relevant SAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

A32. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A34. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and

¹⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 9.

- The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed¹⁶.

A40. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

¹⁶ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 7-17.

I.80 Auditing Pronouncements

Detection Risk

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. SA 300¹⁷ and SA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A45. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

The Nature of Financial Reporting

A46. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting

¹⁷ SA 300, "Planning an Audit of Financial Statements".

practices, including indicators of possible bias in management's judgments¹⁸.

The Nature of Audit Procedures

A47. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A48. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognised in certain financial reporting frameworks (see, for example, the "Framework for the Preparation and Presentation of Financial Statements" issued by the Institute of Chartered Accountants of India (ICAI)). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A49. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the SAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities¹⁹; and
- Use testing and other means of examining populations in a manner that provides a reasonable basis

¹⁸ SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", and Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

¹⁹ SA 315, paragraphs 5-10.

I.82 Auditing Pronouncements

for the auditor to draw conclusions about the population²⁰.

Other Matters that Affect the Inherent Limitations of an Audit

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See SA 240 for further discussion.
- The existence and completeness of related party relationships and transactions. See SA 550 ²¹ for further discussion.
- The occurrence of non-compliance with laws and regulations. See SA 250 ²² for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See SA 570 ²³ for further discussion.

Relevant SAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with SAs

Nature of the SAs (Ref: Para. 18)

A53. The SAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A54. The scope, effective date and any specific limitation of the applicability of a specific SA is made clear in the SA. Unless otherwise stated in the SA, the auditor is permitted to apply an SA before the effective date specified therein.

A55. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the SAs, an audit conducted only in accordance with laws and regulations will not automatically comply with SAs.

A56. The SAs are also relevant to engagements in case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions). The auditor's responsibilities of those entities, however, may be affected by the audit mandate, or by obligations on those

²⁰ SA 330; SA 500; SA 520, "Analytical Procedures", and SA 530, "Audit Sampling".

²¹ SA 550, "Related Parties".

²² SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

²³ SA 570, "Going Concern".

entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the SAs. These additional responsibilities are not dealt with in the SAs. They may be dealt with in the relevant laws and regulations in which the entities are operating.

Contents of the SAs (Ref: Para. 19)

A57. In addition to objectives and requirements (requirements are expressed in the SAs using “shall”), an SA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the SA, and definitions. The entire text of an SA, therefore, is relevant to an understanding of the objectives stated in an SA and the proper application of the requirements of an SA.

A58. Where necessary, the application and other explanatory material provides further explanation of the requirements of an SA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an SA. The application and other explanatory material may also provide background information on matters addressed in an SA.

A59. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.

A60. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the SA, including how the SA relates to other SAs.
- The subject matter of the SA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the SA.
- The context in which the SA is set.

A61. An SA may include, in a separate section under the heading “Definitions”, a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs. The Glossary of Terms relating to Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board contains a complete listing of terms defined in the SAs. It also includes descriptions of other terms found in SAs to assist in common and consistent interpretation.

A62. When appropriate, additional considerations specific to audits of smaller entities and to certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), are included within the application and other explanatory material of an SA. These additional considerations assist in the application of the requirements of the SA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SAs.

Considerations Specific to Smaller Entities

A63. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity”

I.84 Auditing Pronouncements

refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;
 - (ii) Simple record-keeping;
 - (iii) Few lines of business and few products within business lines;
 - (iv) Few internal controls;
 - (v) Few levels of management with responsibility for a broad range of controls; or
 - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A64. The considerations specific to smaller entities included in the SAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A65. The SAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the “owner-manager”.

Objectives Stated in Individual SAs (Ref: Para. 21)

A66. Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A68. In using the objectives, the auditor is required to have regard to the interrelationships among the SAs. This is because, as indicated in paragraph A53, the SAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. At a more detailed level, SA 315 and SA 330 contain, among other things, objectives and requirements that deal with the auditor’s responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An SA dealing with specific aspects of the audit (for example, SA 540) may expand on how the objectives and requirements of such SAs as SA 315 and SA 330 are to be applied in relation to the subject of the SA but does not repeat them. Thus, in achieving the objective stated in SA 540 , the auditor has regard to the objectives and requirements of other relevant SAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

A69. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the SAs by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the SAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the SAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the SAs to meet the objectives specified in the SAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other SAs;
- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances. Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the SAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

A71. In some cases, an SA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in SA 610²⁴ is not relevant.

A72. Within a relevant SA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope²⁵ represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance²⁶, which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework²⁷, which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

²⁴ SA 610, "Using the Work of Internal Auditors".

²⁵ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 13.

²⁶ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9.

²⁷ SA 501, "Audit Evidence – Specific Considerations for Selected Items", paragraph 13.

Departure from a Requirement (Ref: Para. 23)

A73. SA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement²⁸. The SAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Failure to Achieve an Objective (Ref: Para. 24)

A74. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the SAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the SAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an SA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example due to a limitation in the available audit evidence.

A75. Audit documentation that meets the requirements of SA 230 and the specific documentation requirements of other relevant SAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

Modifications *vis-à-vis* ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"

Deletion

Paragraph A11 of ISA 200 deals with the additional responsibilities for the execution of transactions and events in accordance with legislation or proper authority in case of public sector entities. Further, paragraph A57 of ISA 200 (A56 of SA 200) deals with the auditor's additional responsibility arising out of the mandatory or obligatory laws or regulations applicable to that public sector entity. These additional responsibilities are not dealt by the SAs but dealt by the laws or regulations under which the public sector entity operates. Also, paragraph A63 of ISA 200 (A62 of SA 200) deals with the inclusion of the paragraph specific to public sector entities in the application and explanatory material section. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of paragraphs A11, A57 and A63 in ISA, highlighting such fact, has been retained.

²⁸ SA 230, paragraph 12.

SA 210*

Agreeing the Terms of Audit Engagements
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. SA 220¹ deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- (a) Establishing whether the preconditions for an audit are present; and
- (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

4. For purposes of the SAs, the following term has the meaning attributed below:

Preconditions for an audit – The use by management of an acceptable financial reporting framework² in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise³ on which an audit is conducted.

5. For the purposes of this SA, references to "management" should be read hereafter as "management and, where appropriate, those charged with governance".

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:
- (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A9)

*Published in September, 2009 issue of the Journal.

¹ SA 220, "Quality Control for an Audit of Financial Statements", published in March, 2010 issue of the Journal.

² SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", paragraph 13 (a).

³ SA 200, Paragraph 13 (j).

I.88 Auditing Pronouncements

- (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A10-A13, A19)
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A14)
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A15-A18)
 - (iii) To provide the auditor with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - b. Additional information that the auditor may request from management for the purpose of the audit; and
 - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Limitation on Scope Prior to Audit Engagement Acceptance

7. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:
- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or
 - (b) If the agreement referred to in paragraph 6(b) has not been obtained.

Agreement on Audit Engagement Terms

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A20)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A21-A24)

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A21, A25-A26)

12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A25)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A27)

Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A28-A30)

15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A31-A32)

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

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

- (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards⁴ Supplemented by Law or Regulation

18. If financial reporting standards established by an authorised or recognised standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:

- (a) The additional requirements can be met through additional disclosures in the financial statements; or
- (b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with SA 705⁵. (Ref: Para. A33)

⁴ Accounting Standards issued by the ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

⁵ Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report"; published in February, 2010 issue of the Journal.

I.90 Auditing Pronouncements

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A34)

- (a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and
- (b) It is recognised in the terms of the audit engagement that:
 - (i) The auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures, in accordance with SA 706⁶ ; and
 - (ii) Unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases "present fairly, in all material respects", or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:

- (a) Evaluate the effect of the misleading nature of the financial statements on the auditor's report; and
- (b) Include appropriate reference to this matter in the terms of the audit engagement.

Auditor's Report Prescribed by Law or Regulation

21. In some cases, the law or regulation applicable to the entity prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs. In these circumstances, the auditor shall evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding⁷.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with SAs⁸. (Ref: Para. A35-A36)

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics⁹. The auditor's responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they

⁶ Standard on Auditing (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", published in February, 2010 issue of the Journal.

⁷ SA 706.

⁸ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 43.

⁹ "Framework for Assurance Engagements," paragraph 16.

are within the control of the auditor are dealt with in SA 220¹⁰. This SA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users¹¹. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the SAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, or a not for profit organization);
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.

A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. SA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.¹²

¹⁰ SA 220, "Quality Control for an Audit of Financial Statements", paragraphs 9-11.

¹¹ "Framework for Assurance Engagements," paragraph 16(b)(ii).

¹² Standard on Auditing (SA) 800, "Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework", paragraph 8.

I.92 Auditing Pronouncements

A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

A8. At present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and/ or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, as may be applicable;
- Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI);
- International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board; and
- International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. Appendix 2 contains guidance on determining the acceptability of the financial reporting framework. In case of some entities, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

Agreement of the Responsibilities of Management (Ref: Para. 6(b))

A10. An audit in accordance with SAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b)¹³. In case of certain entities, such responsibilities may be specified in the applicable law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. SAs do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an

¹³ SA 200, Paragraph A2.

independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9-12.

A11. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.

A12. SA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities¹⁴. It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other SAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

A13. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence¹⁵. In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

A14. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the financial reporting framework includes presentation. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will "give a true and fair view" in accordance with the financial reporting framework.

Internal Control (Ref: Para. 6(b)(ii))

A15. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives due to the inherent limitations of internal control¹⁶.

A16. An independent audit conducted in accordance with the SAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its

¹⁴ SA 580, "Written Representations," paragraphs 10-11.

¹⁵ SA 580, paragraph A26.

¹⁶ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph A46.

I.94 Auditing Pronouncements

purpose or will be free of deficiencies.

A17. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term “internal control” encompasses a wide range of activities within components that may be described as the control environment; the entity’s risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.¹⁷ An entity’s internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

A18. In some cases, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some other cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A19. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

A20. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

*Audit Engagement Letter or Other Form of Written Agreement*¹⁸ (Ref: Para. 10-11)

A21. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some entities, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A22. The form and content of the audit engagement letter may vary for each entity. Information included in

¹⁷ SA 315, paragraph A51 and Appendix 1.

¹⁸ In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

the audit engagement letter on the auditor's responsibilities may be based on SA 200¹⁹. Paragraphs 6(b) and 12 of this SA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, SAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations (see also paragraph A13).
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

A23. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A24. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;

¹⁹ SA 200, paragraph 3-9.

I.96 Auditing Pronouncements

- Whether a separate auditor's report is to be issued on the component;
- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A25. If, in the circumstances described in paragraphs A22 and A27, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b).

A26. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), law or regulation governing the operations of that entities generally mandate the appointment of the auditor and commonly set out the auditor's responsibilities and powers, including the power to access an entity's records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A27. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

A28. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A29. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

A30. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

A31. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may need to assess, in addition to the matters referred to in paragraphs A29-A31 above, any legal or contractual implications of the change.

A32. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

- (a) The original audit engagement; or
- (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed- upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

A33. In case of some entities, law or regulation may supplement the financial reporting standards established by an authorised or recognised standards setting organization with additional requirements relating to the preparation of financial statements. In such cases, the applicable financial reporting framework for the purposes of applying the SAs encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards²⁰.

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

A34. Law or regulation may prescribe that the wording of the auditor's opinion use the phrases "present fairly, in all material respects" or "give a true and fair view" in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor's report are significantly different from the requirements of SAs (see paragraph 21).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 21)

A35. SAs require that the auditor shall not represent compliance with SAs unless the auditor has complied with all of the SAs relevant to the audit²¹. When law or regulation prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs and the auditor concludes that additional explanation in the auditor's report cannot mitigate possible

²⁰ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 15.

²¹ SA 200, paragraph 20.

misunderstanding, the auditor may consider including a statement in the auditor's report that the audit is not conducted in accordance with SAs. The auditor is, however, encouraged to apply SAs, including the SAs that address the auditor's report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with SAs.

A36. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a regulator or the legislative body or the stakeholders if the entity attempts to limit the scope of the audit.

Material Modifications to ISA 210, "Agreeing the Terms of Audit Engagements"

Addition

Paragraph A8 of ISA 210 provides the examples of the financial reporting standards, which can be used for the preparation and presentation of general purpose financial statements. Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be 'Accounting Standards issued by the Institute of Chartered Accountants of India or Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006' or 'Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI)', these have been added in the list of examples of financial reporting standards. References have accordingly been changed.

Deletions

1. Paragraph A10 of the ISA 210 deals with situations where the entity operates in a jurisdiction that does not have a standard setting organization or a prescribed financial reporting framework. Since in India, this kind of situation does not exist, paragraph A10 has been deleted. However, the reference to Appendix 2, *Determining Acceptability of General Purpose Frameworks*, has been shifted to paragraph A9.
2. Paragraph A27 of ISA 210 deals with the condition where the law or regulation governs the operations of public sector audits, and also prescribes the public sector auditor's responsibilities and powers. Paragraph A37 of ISA 210 deals with the specific reporting requirements within the legislation governing the audit which may mandate; for example, the auditor may be required to report directly to a minister or the legislature or to public if the entity attempts to limit the scope of the audit in case of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted. However, since it is also possible that such situations may also exist in case of certain non-public entities pursuant to a requirement under the statute or regulation under which they operate the spirit of erstwhile A27 and A37 has been retained.

Appendix 1

(Ref: Paras. A22-A23)

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with Financial Reporting Standards²² of a company registered under the Companies Act, 1956. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would

²² Refer footnote 6.

require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this SA). It may be appropriate to seek legal advice that any proposed letter is suitable.

To the Board of Directors of ABC Company Limited:²³

[The objective and scope of the audit]

You²⁴ have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.²⁵

[The responsibilities of the auditor]

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

[The responsibilities of management and identification of the applicable financial reporting framework (for

²³ The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A21.

²⁴ Throughout this letter, references to "you", "we", "us", "management", "those charged with governance" and "auditor" would be used or amended as appropriate in the circumstances.

²⁵ Where the financial statements of the entity include financial statements/ information of its component(s) which have been audited by another auditor/ auditors, the engagement letter may be modified as under:

"You have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Further, as informed by you, the financial statements of the components of ABC Company Limited, viz., PQR Company Limited and XYZ Company Pvt Limited, whose financial information/ financial statements have been included in the financial statements of ABC Company would be/ have been audited by another auditor/ auditors. However, we expect to be furnished the reports of such other auditor(s) before the date of our audit report so as to enable us to deal with such reports in accordance with the principles enunciated in the Standard on Auditing (SA) 600, *Using the Work of Another Auditor*, issued by the Institute of Chartered Accountants of India".

I.100 Auditing Pronouncements

purposes of this example it is assumed that the auditor has determined that the provisions of the Companies Act, 1956 relating to responsibility of the Board of Directors be supplemented by the descriptions in paragraph 6(b) of this SA.)]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]²⁶ acknowledge and understand that they have responsibility:

- (a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.²⁷ This includes:
- the responsibility for the preparation of financial statements on a going concern basis.
 - the responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
 - The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
- (i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - (ii) Additional information that we may request from [management] for the purpose of the audit; and
 - (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

[Other relevant information]

[Insert other information, such as fee arrangements, billings²⁸ and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report.]

²⁶ Use terminology as appropriate in the circumstances.

²⁷ Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".

²⁸ For example, "Our fees will be billed as the work progresses".

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.
Chartered Accountants
Firm's Registration Number
.....
(Signature)

Date : (Name of the Member)

Place : (Designation²⁹)

Acknowledged on behalf of ABC Company by

.....

(Signature)

Name and Designation

Date

Appendix 2

(Ref: Para. A9)

Determining the Acceptability of General Purpose Frameworks

1. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:

- (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.
- (b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.
- (c) Reliability, in that the information provided in the financial statements:
 - (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
 - (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
- (d) Neutrality, in that it contributes to information in the financial statements that is free from bias.
- (e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

2. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to IFRSs. For an audit of a small entity, the auditor may decide to compare the

²⁹ Partner or proprietor, as the case may be.

I.102 Auditing Pronouncements

accounting conventions to a financial reporting framework specifically developed for such entities by an authorised or recognised standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation and presentation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.

3. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the industry to which the entity belongs by preparers and users.

SA 220*

**Quality Control for an Audit of
Financial Statements**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements.

System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
- (b) The reports issued by the firm or engagement partners are appropriate in the circumstances¹.

This SA is premised on the basis that the firm is subject to SQC 1. (Ref: Para. A1)

3. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

4. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

* Published in March, 2010 issue of the Journal.

¹ Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", paragraph 10.

I.104 Auditing Pronouncements

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Engagement partner – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
 - (b) Engagement quality control review – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
 - (c) Engagement quality control reviewer – a partner, other person² in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
 - (d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
 - (e) Firm – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.
 - (f) Inspection – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.
 - (g) Listed entity – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.
 - (h) Monitoring – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.
 - (i) Network firm – A firm or entity that belongs to a network.
 - (j) Network – A larger structure:
 - (i) That is aimed at cooperation, and
 - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
 - (k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
 - (l) Personnel – partners and staff.
 - (m) Professional Standards – Engagement Standards, as defined in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", issued by the Institute of Chartered Accountants of India and relevant ethical requirements as contained in the Code of Ethics issued by the Institute.

² Such other person should be a member of the Institute of Chartered Accountants of India.

- (n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.
- (o) Staff – professionals, other than partners, including any experts which the firm employs.
- (p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee³ (with appropriate experience) of another firm.

Requirements

Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

Independence

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A5-A7)

Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

³ Such employee should be a member of the Institute of Chartered Accountants of India.

I.106 Auditing Pronouncements

Assignment of Engagement Teams

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- (a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and
- (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

Engagement Performance

Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:

- (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and (Ref: Para. A13-A15, A20)
- (b) The auditor's report being appropriate in the circumstances.

Reviews

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)

17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

Consultation

18. The engagement partner shall:

- (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
- (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)

Engagement Quality Control Review

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

- (a) Determine that an engagement quality control reviewer has been appointed;
- (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)

20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report.

This evaluation shall involve:

- (a) Discussion of significant matters with the engagement partner;
 - (b) Review of the financial statements and the proposed auditor's report;
 - (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
 - (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A27, A29-A31)
21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:
- (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;
 - (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
 - (c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached. (Ref: Para. A28-A31)

Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

Documentation

24. The auditor shall document:
- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
 - (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
 - (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
 - (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A35)
25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:
- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
 - (b) The engagement quality control review has been completed on or before the date of the auditor's report; and

I.108 Auditing Pronouncements

- (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Application and Other Explanatory Material

System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

A1. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

Reliance on the Firm's System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- (a) The importance to audit quality of:
- (i) Performing work that complies with professional standards and regulatory and legal requirements;
 - (ii) Complying with the firm's quality control policies and procedures as applicable;
 - (iii) Issuing auditor's reports that are appropriate in the circumstances; and
 - (iv) The engagement team's ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

Relevant Ethical Requirements

Compliance with Relevant Ethical Requirements (Ref: Para. 9)

A4. The Code of Ethics issued by the Institute of Chartered Accountants of India establishes the fundamental principles of professional ethics, which include:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;

- (d) Confidentiality; and
- (e) Professional behavior.

Definition of "Firm", "Network" and "Network Firm" (Ref: Para. 9-11)

A5. The definitions of "firm", "network" or "network firm" in relevant ethical requirements may differ from those set out in this SA. For example, the Code of Ethics of the Institute of Chartered Accountants of India (ICAI) defines the "Network Firm" as:

"Networking amongst two or more firms under common control, ownership or management with the firm or having affiliation with an accounting entity or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally".

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

A7. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), statutory measures may provide safeguards for the independence of auditors of certain entities. However, such auditors or audit firms carrying out audits on behalf of the statutory auditor may, depending on the terms of the applicable legal or regulatory framework, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the auditor's applicable law or regulation does not permit withdrawal of the auditor from the engagement, disclosure through a public report, of circumstances that have arisen that would, have otherwise lead the auditor to withdraw.

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

A8. SQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client⁴. Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

A9. In case of certain entities, such as, Central/State governments and related government entities (for

⁴ SQC 1, paragraph 28.

I.110 Auditing Pronouncements

example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A7 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to the auditors of such entities in performing risk assessments and in carrying out reporting responsibilities.

Assignment of Engagement Teams (Ref: Para. 14)

A10. An engagement team also includes a member using expertise in a specialised area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

A12. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of audit of such entities may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with legislative authorities and preventing and detecting fraud and corruption.

Engagement Performance

Direction, Supervision and Performance (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by SA 200⁵.
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.

⁵ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 15.

- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A15. Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

Reviews

Review Responsibilities (Ref: Para. 16)

A16. Under SQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members⁶.

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

The Engagement Partner's Review of Work Performed (Ref: Para. 17)

A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and

⁶ SQC 1, paragraph 50.

I.112 Auditing Pronouncements

- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by SA 230, the partner documents the extent and timing of the reviews⁷.

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraphs A17 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialised Area of Accounting or Auditing Is Used (Ref: Para. 15-17)

A20. Where a member of the engagement team with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

Consultation (Ref: Para. 18)

A21. Effective consultation on significant technical, ethical, and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

Engagement Quality Control Review

Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))

A23. SA 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements⁸. In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph

⁷ SA 230, "Audit Documentation", paragraph 9(c).

⁸ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. SA 230 establishes requirements and provides guidance in this regard⁹.

Nature, Extent and Timing of Engagement Quality Control Review (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

A27. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with SA 315¹⁰, and the responses to those risks in accordance with SA 330¹¹, including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240¹².
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Considerations Specific to Smaller Entities (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for such audit engagements also that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

Considerations Specific to Central/State Governments and Related Government Entities (Ref: Para. 20-21)

A30. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for certain entities audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for

⁹ SA 230, paragraphs 14-16 and A21-A24.

¹⁰ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

¹¹ SA 330, "The Auditor's Responses to Assessed Risks".

¹² SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

I.114 Auditing Pronouncements

independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A31. Certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may not necessarily be listed entities yet may be significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the certain entities may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, auditors of such entities evaluate which of these entities may be of sufficient significance to warrant performance of an engagement quality control review.

Monitoring (Ref: Para. 23)

A32. SQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control is relevant, adequate and operating effectively¹³.

A33. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A34. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

Documentation

Documentation of Consultations (Ref: Para. 24(d))

A35. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Modifications vis-à-vis ISA 220, "Quality Control for an Audit of Financial Statements"

Deletion

Paragraphs A7, A9, A12, A30 and A31 of the Application Section of ISA 220 dealt with the application of the requirements of ISA 220 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that these requirements may also exist in case of non public sector entities pursuant to a requirement under the statute. Accordingly, the spirit of paragraphs A7, A9, A12, A30 and A31 has, accordingly, been made more generic in its application.

¹³ SQC 1, Paragraph 86.

SA 230*

Audit Documentation
***(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:

- (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

3. Audit documentation serves a number of additional purposes, including the following:

- ◆ Assisting the engagement team to plan and perform the audit.
- ◆ Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220¹.
- ◆ Enabling the engagement team to be accountable for its work.
- ◆ Retaining a record of matters of continuing significance to future audits.
- ◆ Enabling the conduct of quality control reviews and inspections in accordance with SQC 1².
- ◆ Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

5. The objective of the auditor is to prepare documentation that provides:

* Published in January, 2009 issue of the Journal.

¹ SA 220, "Quality Control for an Audit of Financial Statements", paragraph 15-17.

² SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", paragraphs 46, 60, 63, 65 and 85.

I.116 Auditing Pronouncements

- (a) A sufficient and appropriate record of the basis for the auditor's report; and
- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) **Audit documentation** – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).
 - (b) **Audit file** – One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
 - (c) **Experienced auditor** – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
 - (i) Audit processes;
 - (ii) SAs and applicable legal and regulatory requirements;
 - (iii) The business environment in which the entity operates; and
 - (iv) Auditing and financial reporting issues relevant to the entity's industry.

Requirements

Timely Preparation of Audit Documentation

7. The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16- A17)
- (a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; (Ref: Para. A6-A7)
 - (b) The results of the audit procedures performed, and the audit evidence obtained; and
 - (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8- A11)
9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
- (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)
 - (b) Who performed the audit work and the date such work was completed; and
 - (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)
10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para. A14)
11. If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (Ref: Para. A15)

Departure from a Relevant Requirement

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement

in a SA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Ref: Para. A18-A19)

Matters Arising after the Date of the Auditor's Report

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document: (Ref: Para. A20)

- (a) The circumstances encountered;
- (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- (c) When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the Final Audit File

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. (Ref: Para. A21-A22)

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. (Ref: Para. A23)

16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document: (Ref: Para. A24 -A25)

- (a) The specific reasons for making them; and
- (b) When and by whom they were made and reviewed.

Application and Other Explanatory Material

Timely Preparation of Audit Documentation (Ref: Para. 7)

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation (Ref: Para. 8)

A2. The form, content and extent of audit documentation depend on factors such as:

- ◆ The size and complexity of the entity.
- ◆ The nature of the audit procedures to be performed.
- ◆ The identified risks of material misstatement.
- ◆ The significance of the audit evidence obtained.
- ◆ The nature and extent of exceptions identified.
- ◆ The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- ◆ The audit methodology and tools used.

I.118 Auditing Pronouncements

A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- ◆ Audit programmes.
- ◆ Analyses.
- ◆ Issues memoranda.
- ◆ Summaries of significant matters.
- ◆ Letters of confirmation and representation.
- ◆ Checklists.
- ◆ Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of Compliance with SAs (Ref: Para. 8(a))

A6. In principle, compliance with the requirements of this SA will result in the audit documentation being sufficient and appropriate in the circumstances. Other SAs contain specific documentation requirements that are intended to clarify the application of this SA in the particular circumstances of those SAs. The specific documentation requirements of other SAs do not limit the application of this SA. Furthermore, the absence of a documentation requirement in any particular SA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that SA.

A7. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- ◆ The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- ◆ The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- ◆ An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- ◆ In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
 - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's

exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.

- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315³.

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- ◆ Matters that give rise to significant risks (as defined in SA 315)⁴.
- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ◆ The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- ◆ The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- ◆ The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross- references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews

³ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10.

⁴ SA 315, paragraph 4(e).

I.120 Auditing Pronouncements

and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer (Ref: Para. 9)

A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- ◆ For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- ◆ For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
- ◆ For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- ◆ For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- ◆ For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A13. SA 220⁵ requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others (Ref: Para. 10)

A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of How Inconsistencies have been addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref: Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team

⁵ SA 220, paragraph 17.

(for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, determined in accordance with SA 320⁶, assessed risks, significant matters noted during the audit, and conclusions reached.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant⁷ only in the cases where:

- (a) The entire SA is not relevant [for example, if an entity does not have an internal audit function, nothing in SA 610⁸ is relevant]; or
- (b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

Matters Arising after the Date of the Auditor's Report (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.⁹ The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in SA 220¹⁰, with the engagement partner taking final responsibility for the changes.

Assembly of the Final Audit File (Ref: Para. 14-16)

A21. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files.¹¹ An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.¹²

A22. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if

⁶ SA 320, "Materiality in Planning and Performing an Audit".

⁷ Refer paragraph 22 of SA 200.

⁸ SA 610, "Using the Work of Internal Auditors."

⁹ SA 560, "Subsequent Events", paragraph 13.

¹⁰ SA 220, paragraph 16.

¹¹ Refer para 74 of SQC 1.

¹² Refer para 75 of SQC 1.

I.122 Auditing Pronouncements

they are administrative in nature. Examples of such changes include:

- ◆ Deleting or discarding superseded documentation.
- ◆ Sorting, collating and cross referencing working papers.
- ◆ Signing off on completion checklists relating to the file assembly process.
- ◆ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

A23. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation.¹³ The retention period for audit engagements ordinarily is no shorter than seven years¹⁴ from the date of the auditor's report, or, if later, the date of the group auditor's report.¹⁵

A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

Ownership of Audit Documentation

A25. Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Material Modifications to ISA 230, "Audit Documentation"

Addition

1. Paragraph A23 of ISA 230 prescribes the minimum period of engagement documentation as five years. The SA 230 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, and regulations made there under, prescribe the minimum period of retention of working papers as seven years.
2. An additional paragraph A25 has been added from SQC 1, giving provisions regarding Ownership of Audit Documentation.

¹³ Refer para 82 of SQC 1.

¹⁴ The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, 'Audit Documentation', issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

¹⁵ Refer para 83 of SQC 1.

SA 240*

**The Auditor's Responsibilities Relating to Fraud
In An Audit of Financial Statements
(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)**

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," and SA 330, "The Auditor's Responses to Assessed Risks," are to be applied in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

3. Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly

* Published in December, 2007 issue of the Journal.

I.124 Auditing Pronouncements

planned and performed in accordance with the SAs.¹

6. As described in SA 200², the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

8. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

Objectives

10. The objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to identified or suspected fraud.

Definitions

11. For purposes of the SAs, the following terms have the meanings attributed below:

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

¹ SA 200, paragraph A51.

² SA 200, paragraph A51.

Requirements

Professional Skepticism

12. In accordance with SA 200³, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion Among the Engagement Team

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion⁴. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by SA 315⁵, the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

- (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)
- (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)
- (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

³ SA 200, paragraph 15.

⁴ SA 315, paragraph 10.

⁵ SA 315, paragraphs 5-24.

I.126 Auditing Pronouncements

19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity⁶, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

Unusual or Unexpected Relationships Identified

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Other Information

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures⁷.

26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)

27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

⁶ SA 260, "Communication with Those Charged with Governance", paragraph 12 (c).

⁷ SA 315, Paragraph 25.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

28. In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.⁸ (Ref: Para. A33)

29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

- (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)
- (b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
- (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

30. In accordance with SA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.⁹ (Ref: Para. A37-A40)

Audit Procedures Responsive to Risks Related to Management Override of Controls

31. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

32. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
 - (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
 - (ii) Select journal entries and other adjustments made at the end of a reporting period; and
 - (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)
- (b) Review accounting estimates¹⁰ for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor

⁸ SA 330, paragraph 5.

⁹ SA 330, paragraph 6.

¹⁰ Reference may be made to SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

I.128 Auditing Pronouncements

shall:

- (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and
 - (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year¹¹. (Ref: Para. A45-A46)
- (c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A47)

33. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).

Evaluation of Audit Evidence (Ref: Para. A48)

34. The auditor shall evaluate whether analytical procedures¹² that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49)

35. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A50)

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51)

37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)

¹¹ Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires the adjustment of the prior period estimates, which may affect both the period of change in the Accounting Estimates and subsequent periods, in subsequent years.

¹² Reference may be made to SA 520, "Analytical Procedures".

Auditor Unable to Continue the Engagement

38. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
- (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A53-A56)

Management Representations

39. The auditor shall obtain written representations from management and, where applicable, those charged with governance that:

- (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- (b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- (c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:
 - (i) Management;
 - (ii) Employees who have significant roles in internal control; or
 - (iii) Others where the fraud could have a material effect on the financial statements; and
- (d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- (a) Management;
- (b) Employees who have significant roles in internal control; or
- (c) Others where the fraud results in a material misstatement in the financial statements.

I.130 Auditing Pronouncements

The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A60-A62)

42. In accordance with SA 260, Communication with Those Charged with Governance¹³, the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A63)

Communications to Regulatory and Enforcement Authorities

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

Documentation

44. The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315¹⁴ shall include:

- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and
- (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

45. The auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330¹⁵ shall include:

- (a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- (b) The results of the audit procedures, including those designed to address the risk of management override of controls.

46. The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

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

Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under

¹³ Reference may be made to SA 260, "Communication with Those Charged with Governance".

¹⁴ SA 315, paragraph 32.

¹⁵ SA 330, paragraph 28.

pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are

I.132 Auditing Pronouncements

usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

A6. The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/by the entity in his report. For example, Clause (xxi) of Paragraph 4 of the Companies (Auditor's Report) Order, 2003 requires the auditor to specifically report "whether any fraud on or by the entity has been noticed or reported during the year; if yes, the nature and amount involved is to be indicated". Similarly, in case of audit of banks, the auditors, in terms of the circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref: Para. 12-14)

A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. As explained in SA 200, an audit performed in accordance with SAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication.¹⁶ However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

¹⁶ SA 200, paragraph A47.

Discussion among the Engagement Team (Ref: Para. 15)

A10. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud [Ref: Para. 17(a)]

A12. Management accepts responsibility for the entity's internal control and for the preparation of the entity's

I.134 Auditing Pronouncements

financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. SA 315 and SA 610, establishes requirements and provides guidance in audits of those entities that have an internal audit function.¹⁷ In carrying out the requirement of those SAs in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.

¹⁷ SA 315, paragraph 23 and SA 610, "Using the Work of Internal Auditors".

- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 20)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many entities, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.¹⁸

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and

¹⁸ SA 260, "Communication with Those Charged with Governance", paragraphs A1-A8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

I.136 Auditing Pronouncements

whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A26. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

Risks of Fraud in Revenue Recognition (Ref: Para. 26)

A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 27)

A31. As explained in SA 315 management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.¹⁹ In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A35. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

A36. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

¹⁹ SA 315, paragraph A48.

I.138 Auditing Pronouncements

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

A37. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
 - Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
 - The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A38. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts

and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 32(a))

A41. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- The assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- The entity's financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
- The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or

I.140 Auditing Pronouncements

other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.

- The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- Journal entries or other adjustments processed outside the normal course of business – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 32(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 32(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 32(b))

A45. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions (Ref: Para. 32(c))

A47. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.

- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref: Para. 34-37)

A48. SA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.²⁰ This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review of the Financial Statements (Ref: Para. 34)

A49. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 35-37)

A50. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A52. SA 450, "Evaluation of Misstatements Identified during the Audit"²¹, and SA 700, "Forming an Opinion and Reporting on Financial Statements", establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement (Ref: Para. 38)

A53. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

- (a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

²⁰ SA 330, paragraph 25.

²¹ SA 450, "Evaluation of Misstatements Identified during the Audit", paragraphs 12-19.

I.142 Auditing Pronouncements

- (b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- (c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A54. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary under different legislations and regulations and, accordingly, the clients. Under some legislations/regulations, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others²².

A56. In some cases, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the terms of appointment or public interest considerations.

Management Representations (Ref: Para. 39)

A57. SA 580, "Written Representations²³", establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A58. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- (a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- (b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

A59. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a

²² The Code of Ethics issued by the Institute of Chartered Accountants of India contains guidance on communication between the outgoing and incoming auditor.

²³ SA 580, "Written Representations".

matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication with Those Charged with Governance (Ref: Para. 41)

A60. The auditor's communication with those charged with governance may be made orally or in writing. SA 260 identifies factors the auditor considers in determining whether to communicate orally or in writing.²⁴ Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A61. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A62. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Communications to Regulatory and Enforcement Authorities (Ref: Para. 43)

A64. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by law & statute and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some entities, for example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e., the Reserve Bank of India, in terms of the latter's circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with

²⁴ SA 260, Paragraph A42.

I.144 Auditing Pronouncements

governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

A66. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

Material Modifications to ISA 240, The Auditor's Responsibility relating to Fraud in an Audit of Financial Statements

Addition

In paragraph A64, the guidance has been made more entity specific, in the context of Indian legal requirement, by way of an example.

Deletions

1. Paragraph A6 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A6, highlighting the fact that in some cases, the auditors may be required by the legislature or the regulator to specifically report on the instances of actual/suspected fraud in the client entity, has been retained and examples of such situations have also been added.

2. Paragraph A56 of the Application Section of ISA 240 dealt with the considerations specific to public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that option of withdrawal may not be available in case of non public sector entities pursuant to a requirement under the statute or terms of appointment of the auditor. Accordingly, the spirit of erstwhile A56, highlighting that in some cases, the auditors may not be having an option to withdraw from the engagement has been retained.

3. Paragraph A66 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of A66 as given in ISA 240, highlighting the fact that in some cases, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation, has been retained.

Appendix 1

(Ref: Para. A25)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with

I.146 Auditing Pronouncements

governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.²⁵
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

²⁵ Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships

I.148 Auditing Pronouncements

may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Appendix 2

(Ref: Para. A40)

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for

I.150 Auditing Pronouncements

example, an allowance for sales returns, were resolved with the benefit of hindsight.

- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.

- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Appendix 3

(Ref: Para. A48)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.

- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

SA 250*

**Consideration of Laws and Regulations
in an Audit of Financial Statements**
(Effective for all audits commencing on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. This SA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Effect of Laws and Regulations

2. The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

Responsibility of Management for Compliance with Laws and Regulations

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. (Ref: Para. A1-A2)

Responsibility of the Auditor (Ref: Para. A3-A6)

4. The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.² In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in

* Published in December, 2008 issue of the Journal.

² SA 200, paragraph 5.

accordance with the SAs.³ In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

6. This SA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

- (a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. (see paragraph 13); and
- (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

7. In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by SA 200,⁴ is important in this context, given the extent of laws and regulations that affect the entity.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

10. The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws

³ SA 200, paragraph 52.

⁴ SA 200, paragraph 15.

I.156 Auditing Pronouncements

and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

- (b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- (c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Definition

11. For the purposes of this SA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Requirements

The Auditor's Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with SA 315,⁵ the auditor shall obtain a general understanding of:

- (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
- (b) How the entity is complying with that framework. (*Ref: Para. A7*)

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. (*Ref: Para. A8*)

14. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

- (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. (*Ref: Para. A9-A10*)

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (*Ref: Para. A11*)

16. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (*Ref: Para. A12*)

17. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12-16.

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11.

Audit Procedures When Non-Compliance is Identified or Suspected

18. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para. A13)

- (a) An understanding of the nature of the act and the circumstances in which it has occurred; and
- (b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A14)

19. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. (Ref: Para. A15-A16)

20. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

21. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. (Ref: Para. A17-A18)

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Those Charged with Governance

22. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,⁶ the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

23. If, in the auditor's judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

24. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705⁷, express a qualified or adverse opinion on the financial statements.

26. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

⁶ SA 260, "Communication with Those Charged with Governance", paragraph 9.

⁷ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 7-8.

I.158 Auditing Pronouncements

27. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. (Ref: Para. A19-A20)

Documentation

29. The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.⁸ (Ref: Para. A21)

Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations

Responsibility of Management for Compliance with Laws and Regulations (Ref: Para. 3)

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework⁹. They may also establish certain legal rights and obligations of the entity, some of which will be recognised in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.

⁸ SA 230, "Audit Documentation", paragraphs 8-11, and paragraph A6.

⁹ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", paragraph 13 (a).

- A compliance function.

Responsibility of the Auditor (Ref: Para. 4-8)

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, Revised SA 700¹⁰ or SA 800¹¹ deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

A6. In some audit engagements, specially those relating to audit of government ventures and undertakings, etc., there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

The Auditor's Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 12)

A7. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

Laws and Regulations Generally Recognised to have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements (Ref: Para. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

¹⁰ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; paragraph 38.

¹¹ SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 11.

I.160 Auditing Pronouncements

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations (Ref: Para. 14)

A9. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

A10. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 14 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

Non-Compliance brought to the Auditor's Attention by Other Audit Procedures (Ref: Para. 15)

A11. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:

- Reading minutes;
- Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 16)

A12. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the

auditor.¹²

Audit Procedures When Non-Compliance is Identified or Suspected

Indications of Non-Compliance with Laws and Regulations (Ref: Para. 18)

A13. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Matters Relevant to the Auditor's Evaluation (Ref: Para. 18(b))

A14. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- The potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures (Ref: Para. 19)

A15. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

A16. If management or, as appropriate, those charged with governance do not provide sufficient information

¹² SA 580, "Written Representations", paragraph 3.

I.162 Auditing Pronouncements

to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's legal counsel or when the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A18. In exceptional cases, the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter(s) paragraph in the auditor's report.¹³

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary under different laws and regulations and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. Under the present legal and regulatory framework for financial institutions in India, their auditor has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. For example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

A20. In case of certain entities, such as national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises), the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report.

Documentation (Ref: Para. 29)

¹³ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

A21. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

Material Modifications to ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"

Deletions

1. Paragraph A6 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the additional audit responsibilities with respect to the consideration of laws and regulations. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations. Accordingly, the spirit of erstwhile A6, highlighting the fact that in case of certain entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations, has been retained.

2. Paragraph A20 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the obligation to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Accordingly, the spirit of erstwhile A20, highlighting the fact that in case of certain entities, there may be instances of reporting non-compliance to governing authorities or to report them in the auditor's report, has been retained.

Standard on Auditing (SA) 260 (Revised), Communication with Those Charged with Governance

(Effective for all audits commencing on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.
2. This SA is written in the context of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation of the other historical financial information.
3. Recognizing the importance of effective two-way communication in an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs (see Appendix 1). In addition, SA 265¹ establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other SAs, may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A33–A36)

The Role of Communication

4. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:
 - a. The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;
 - b. The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

¹ SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*.

c. Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

5. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility.

Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

6. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

7. Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

9. The objectives of the auditor are:

- (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- (b) To obtain from those charged with governance information relevant to the audit;
- (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
- (d) To promote effective two-way communication between the auditor and those charged with governance.

Definitions

10. For purposes of the SAs, the following terms have the meanings attributed below:

(a) **Those charged with governance** – The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1–A8.

(b) **Management** – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

Requirements

Those Charged with Governance

11. The auditor shall determine the appropriate person(s) within the entity's governance structure with

I.166 Auditing Pronouncements

whom to communicate. (Ref: Para. A1–A4)

Communication with a Subgroup of Those Charged with Governance

12. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5–A7)

When All of Those Charged with Governance Are Involved in Managing the Entity

13. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A8)

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

14. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9–A10)

Planned Scope and Timing of the Audit

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: Para. A11–A16)

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

- (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)
- (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)
- (c) Unless all of those charged with governance are involved in managing the entity:
 - i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)
 - ii. Written representations the auditor is requesting;
- (d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)
- (e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process. (Ref: Para. A26–A28)

Auditor Independence

17. In the case of listed entities, the auditor shall communicate with those charged with governance:
- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
 - i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
 - ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level. (Ref: Para. A29–A32)

The Communication Process

Establishing the Communication Process

18. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A37–A45)

Forms of Communication

19. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A46–A48)

20. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

Timing of Communications

21. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A49–A50)

Adequacy of the Communication Process

22. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A51–A53)

Documentation

23. Where matters required by this SA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.² (Ref: Para. A54)

² SA 230, *Audit Documentation*, paragraphs 8–11, and A6.

Application and Other Explanatory Material

Those Charged with Governance (Ref: Para. 11)

A1. Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some entities, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a “two-tier board” structure). In other entities, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a “one-tier board” structure).
- In some entities, those charged with governance hold positions that are an integral part of the entity’s legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.
- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In some cases, those charged with governance are responsible for approving³ the entity’s financial statements (in other cases management has this responsibility).

A2. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A3. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor’s understanding of an entity’s governance structure and processes obtained in accordance with SA 315⁴ is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A4. SA 600 includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

³ As described in paragraph A60 of SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

⁴ SA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 12)

A5. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A6. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prohibited by law or regulation, the auditor retains the right to communicate directly with the governing body.

A7. Audit committees (or similar subgroups with different names) exist in many entities. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance Are Involved in Managing the Entity (Ref: Para.13)

A8. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 14)

A9. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement.⁵ Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising during the audit of the financial statements

⁵ See paragraph 10 of SA 210, *Agreeing the Terms of Audit Engagements*.

I.170 Auditing Pronouncements

that are relevant to those charged with governance in overseeing the financial reporting process.

- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When SA 701⁶ applies, the auditor's responsibilities to determine and communicate key audit matters in the auditor's report.
- When applicable, the auditor's responsibility for communicating particular matters required by law or regulation, by agreement with the entity or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body.

A10. Law or regulation, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 15)

A11. Communication regarding the planned scope and timing of the audit may:

- Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and
- Assist the auditor to understand better the entity and its environment.

A12. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

A13. Matters communicated may include:

- (a) How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.
- (b) How the auditor plans to address areas of higher assessed risks of material misstatement.
- (c) The auditor's approach to internal control relevant to the audit.
- (d) The application of the concept of materiality in the context of an audit.⁷
- (e) The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.⁸
- (f) When SA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work

⁶ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

⁷ SA 320, *Materiality in Planning and Performing an Audit*.

⁸ See SA 620, 'Using the Work of an Auditor's Expert'.

together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.⁹

- The views of those charged with governance of:
 - The appropriate person(s) in the entity's governance structure with whom to communicate.
 - The allocation of responsibilities between those charged with governance and management.
 - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
 - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
 - Significant communications with regulators.
 - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A15. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

A16. Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

Significant Findings from the Audit (Ref: Para. 16)

A17. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

A18. When SA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor's determination of matters that required significant auditor attention and which therefore may be key audit matters.¹⁰

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

⁹ SA 610 (Revised), 'Using the Work of Internal Auditors', paragraph 31.

¹⁰ SA 701, paragraphs 9–10.

I.172 Auditing Pronouncements

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to “critical accounting estimates” or “critical accounting policies and practices” to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor’s views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor’s evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks. Open and constructive communication about significant qualitative aspects of the entity’s accounting practices also may include comment on the acceptability of significant accounting practices. Appendix 2 identifies matters that may be included in this communication.

Significant Difficulties Encountered during the Audit (Ref: Para. 16(b))

A21. Significant difficulties encountered during the audit may include such matters as:

- (i) Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor’s procedures.
- (ii) An unreasonably brief time within which to complete the audit.
- (iii) Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- (iv) The unavailability of expected information.
- (v) Restrictions imposed on the auditor by management.
- (vi) Management’s unwillingness to make or extend its assessment of the entity’s ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor’s opinion.¹¹

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(c)(i))

A22. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Significant events or transactions that occurred during the year.
- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management’s consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.
- Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.

¹¹ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*.

Circumstances that Affect the Form and Content of the Auditor's Report (Ref: Para 16(d))

A23. SA 210 requires the auditor to agree the terms of the audit engagement with management or those charged with governance, as appropriate.¹² The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor's report.¹³ As explained in paragraph A9, if the terms of engagement are not agreed with those charged with governance, the auditor may provide those charged with governance with a copy of the engagement letter to communicate about matters relevant to the audit. The communication required by paragraph 16(d) is intended to inform those charged with governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.

A24. Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the SAs, and for which communication with those charged with governance is required, include when:

- The auditor expects to modify the opinion in the auditor's report in accordance with SA 705 (Revised).¹⁴
- A material uncertainty related to going concern is reported in accordance with SA 570 (Revised).¹⁵
- Key audit matters are communicated in accordance with SA 701.¹⁶
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matters paragraph in accordance with SA 706 (Revised)¹⁷ or is required to do so by other SAs.

In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

A25. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report in accordance with SA 700 (Revised), the auditor is required to discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat. The auditor also may communicate with those charged with governance in circumstances when the auditor elects not to include the description of the auditor's responsibilities in the body of the auditor's report as permitted by SA 700 (Revised).¹⁸

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

A26. SA 300¹⁹ notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. The auditor may communicate with those charged with governance about such matters, for example, as an update to initial discussions about the planned scope

¹² SA 210, paragraph 9.

¹³ SA 210, paragraph 10.

¹⁴ SA 705 (Revised), paragraph 30.

¹⁵ SA 570 (Revised), 'Going Concern', paragraph 25(d).

¹⁶ SA 701, paragraph 17.

¹⁷ SA 706 (Revised), 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', paragraph 12.

¹⁸ SA 700 (Revised), paragraph 40.

¹⁹ SA 300, 'Planning an Audit of Financial Statements', paragraph A14.

I.174 Auditing Pronouncements

and timing of the audit.

A27. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, in accordance with SA 220.²⁰

Auditor Independence (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.²¹

A30. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

- (a) Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and
- (b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

A31. Relevant ethical requirements or law or regulation may also specify particular communications to those charged with governance in circumstances where breaches of independence requirements have been identified. For example, the Code of Ethics issued by ICAI requires the auditor to communicate with those charged with governance in writing about any breach and the action the firm has taken or proposes to take.

A32. The communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A33. The oversight of management by those charged with governance includes ensuring that the entity designs, implements and maintains appropriate internal control with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A34. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant issues

²⁰ See paragraphs 19–21 and A23–A31 of SA 220, *Quality Control for an Audit of Financial Statements*.

²¹ SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing*, paragraph 14.

regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.

A35. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind of which the auditor has become aware with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A36. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

- (a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;
- (b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and
- (c) No procedures were carried out to determine whether other such matters exist.

The Communication Process

Establishing the Communication Process (Ref: Para. 18)

A37. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A38. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the engagement team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A39. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A52).

Considerations Specific to Smaller Entities

A40. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A41. Many matters may be discussed with management in the ordinary course of an audit, including

I.176 Auditing Pronouncements

matters required by this SA to be communicated with those charged with governance. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A42. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognizing management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

A43. Those charged with governance may be required by law or regulation, or may wish, to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

- That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;
- That no responsibility is assumed by the auditor to third parties; and
- Any restrictions on disclosure or distribution to third parties.

A44. In some entities, the auditor may be required by law or regulation to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as a central authority in the case of some public sector entities; or
- Make reports prepared for those charged with governance publicly available.

A45. Unless required by law or regulation to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication (Ref: Para. 19)

A46. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 19–20 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A47. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- (a) Whether a discussion of the matter will be included in the auditor's report. For example, when key audit matters are communicated in the auditor's report, the auditor may consider it necessary to

communicate in writing about the matters determined to be key audit matters.

- (b) Whether the matter has been satisfactorily resolved.
- (c) Whether management has previously communicated the matter.
- (d) The size, operating structure, control environment, and legal structure of the entity.
- (e) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- (f) Legal requirements. In some entities, a written communication with those charged with governance is required in a prescribed form by local law.
- (g) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- (h) The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- (i) Whether there have been significant changes in the membership of a governing body.

A48. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications (Ref: Para. 21)

A49. Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between those charged with governance and the auditor. However, the appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- (a) Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- (b) It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified, prior to communicating these in writing as required by SA 265.²²
- When SA 701 applies, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit (see paragraph A13), and the auditor also may have more frequent communications to further discuss such matters when communicating about significant audit findings.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion.
- Communications regarding findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices, may also be made as part of the concluding discussion.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

²² SA 265, paragraphs 9 and A14.

I.178 Auditing Pronouncements

A50. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process (Ref: Para. 22)

A51. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A52. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.²³ Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A53. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.

²³ SA 315, paragraph A70.

- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Documentation (Ref: Para. 23)

A54. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Appendix 1

(Ref: Para. 3)

Specific Requirements in SQC 1 and Other SAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in SQC 1¹ and other SAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* – paragraph 42(a).
- SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 21, 38(c)(i) and 40-42.
- SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 14, 19 and 22-24.
- SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9.
- SA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12-13.
- SA 505, *External Confirmations* – paragraph 9.
- SA 510, *Initial Audit Engagements—Opening Balances* – paragraph 7.
- SA 550, *Related Parties* – paragraph 27.
- SA 560, *Subsequent Events*— paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17.
- SA 570 (Revised), *Going Concern* – paragraph 25.
- SA 610 (Revised), *Using the Work of Internal Auditors* – paragraphs 20 and 31.
- SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17.
- SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30.
- SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12.

¹ SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*.

I.180 Auditing Pronouncements

- SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* - paragraph 18.
- SA 720, *The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements* – paragraphs 10, 13 and 16.

Appendix 2

(Ref: Para. 16(a), A19–A20)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in SA 540,¹ including, for example:
 - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
 - Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
 - Whether management's decision to recognize, or to not recognize, the accounting estimates in the financial statements is in accordance with the applicable financial reporting framework.
 - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the outcome of accounting estimates in prior periods.
 - Management's process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.
 - Whether the significant assumptions used by management in developing the accounting estimate

¹ SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.

are reasonable.

- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
- Risks of material misstatement.
- Indicators of possible management bias.
- How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- The adequacy of disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. This communication may highlight:
 - The non-recurring amounts recognized during the period.
 - The extent to which such transactions are separately disclosed in the financial statements.
 - Whether such transactions appear to have been designed to achieve a particular accounting or tax treatment, or a particular legal or regulatory objective.
 - Whether the form of such transactions appears overly complex or where extensive advice regarding the structuring of the transaction has been taken.
 - Where management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

SA 265*

**Communicating Deficiencies in Internal Control to
Those Charged with Governance and Management**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control²⁴ that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330²⁵. SA 260²⁶ establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.
2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement²⁷. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.
3. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

* Published in September, 2009 issue of the Journal.

²⁴ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 4 and 12.

²⁵ SA 330, "The Auditor's Responses to Assessed Risks".

²⁶ SA 260, "Communication with Those Charged with Governance".

²⁷ SA 315, paragraph 12.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Deficiency in internal control – This exists when:
 - (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
 - (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
 - (b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor’s professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

Requirements

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)
8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)
9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12- A18, A27)
10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)
- (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21)
 - (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention. (Ref: Para. A22- A26)
11. The auditor shall include in the written communication of significant deficiencies in internal control:
- (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)
 - (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)
 - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;
 - (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
 - (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Application and Other Explanatory Material

Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para. 7)

- A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor’s findings with the appropriate level

I.184 Auditing Pronouncements

of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).

A2. In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
- A preliminary indication from management of its response to the findings.

Considerations Specific to Smaller Entities

A3. While the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A4. Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

Significant Deficiencies in Internal Control (Ref: Para. 6(b), 8)

A5. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit.

A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:

- General monitoring controls (such as oversight of management).
 - Controls over the prevention and detection of fraud.
 - Controls over the selection and application of significant accounting policies.
 - Controls over significant transactions with related parties.
 - Controls over significant transactions outside the entity's normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
 - The interaction of the deficiency with other deficiencies in internal control.
- A7. Indicators of significant deficiencies in internal control include, for example:
- Evidence of ineffective aspects of the control environment, such as:
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
 - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
 - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
 - Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
 - Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
 - Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
 - Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
 - Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss²⁸.
 - Evidence of management's inability to oversee the preparation of the financial statements.
- A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements²⁹. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure,

²⁸ Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

²⁹ SA 315, paragraph A66.

relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this SA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this SA to be communicated to those charged with governance.

A11. The requirements of this SA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.³⁰

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, in case of listed entities, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement³¹ for the auditor to complete the assembly of the final audit file on a timely basis. SA 230 states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report³².

A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this SA requires.

³⁰ SA 260, paragraph 9.

³¹ SA 230, "Audit Documentation", paragraph 14.

³² SA 230, paragraph A21.

A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature of the entity. For instance, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For instance, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.
- The entity's governance composition. For instance, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

Communication of Deficiencies in Internal Control to Management (Ref: Para. 10)

A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

I.188 Auditing Pronouncements

A21. SA 250 establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance³³. SA 240 establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management³⁴.

Communication of Other Deficiencies in Internal Control to Management (Ref: Para. 10(b))

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

A23. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as internal auditors or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

A26. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity³⁵.

A27. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this SA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Law, regulation or other authority may also mandate that the auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require the auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this SA, for example, controls related

³³ SA 250, Consideration of Laws and Regulations in an Audit of Financial Statements, paragraphs 22-28.

³⁴ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 41.

³⁵ SA 260, paragraph 9.

to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

Content of Written Communication of Significant Deficiencies in Internal Control (Ref: Para. 11)

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

A29. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

Material Modifications to ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"

Deletions

1 Paragraph A7 of ISA 265 provides the examples of the indicators of significant deficiencies in internal control which may include restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud. Since in India Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss.

2. Paragraph A27 of ISA 265 deals with the additional responsibilities of the public sector auditors to communicate/report deficiencies in internal control to the legislature or governing body. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such additional responsibilities may also be imposed on the auditor in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A22, highlighting the fact, has been retained though a specific reference to public sector entities has been deleted.

SA 299

Responsibility of Joint Auditors
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 1996)*

Introduction

1. The practice of appointing more than one auditor to conduct the audit of large entities is in vogue these days. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The Standard does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more divisions or branches included in the financial statements of the entity, e.g., the relationship between a company auditor appointed under section 224 of the Companies Act, 1956 and a branch auditor appointed under section 228 of the said Act.¹

Division of Work

2. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

3. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Coordination

4. Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This should be done by the submission of a report or note prior to the finalisation of the audit.

Relationship Among Joint Auditors

5. In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

- (a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- (b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature,

¹ These aspects have been dealt with in Standard on Auditing (SA) 600, "Using the Work of Another Auditor".

timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

- (c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- (d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- (e) for ensuring that the audit report complies with the requirements of the relevant statute.

6. If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7. Subject to paragraph 5(b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

8. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

9. A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

10. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures.² It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

11. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the

² Reference may be made in this regard to the Standards on Auditing and other mandatory Statements relating to auditing matters issued by the Council of the Institute from time to time.

I.192 Auditing Pronouncements

legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

Reporting Responsibilities

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

Effective Date

13. This Standard on Auditing becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

SA 300*

Planning an Audit of Financial Statements
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2008)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified. (Ref: Para. A1-A4)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after 1st April 2008.

Objective

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

Requirements

Involvement of Key Engagement Team Members

4. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A5)

Preliminary Engagement Activities

5. The auditor shall undertake the following activities at the beginning of the current audit engagement:
- (a) Performing procedures required by SA 220¹, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement;
 - (b) Evaluating compliance with ethical requirements, including independence, as required by SA 220²; and
 - (c) Establishing an understanding of the terms of the engagement, as required by SA 210³. (Ref: Para. A6-A8)

Planning Activities

6. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
7. In establishing the overall audit strategy, the auditor shall:
- (a) Identify the characteristics of the engagement that define its scope;

*Published in December, 2007 issue of the Journal.

¹ SA 220, paragraph 12-13.

² SA 220, paragraph 9-11.

³ SA 210, "Agreeing the Terms of Audit Engagements," paragraphs 9-13.

I.194 Auditing Pronouncements

- (b) *Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;*
 - (c) *Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;*
 - (d) *Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and*
 - (e) *Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A9-A12)*
8. *The auditor shall develop an audit plan that shall include a description of:*
- (a) *The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".*
 - (b) *The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".*
 - (c) *Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)*
9. *The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)*
10. *The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A15-A16)*

Documentation

11. *The auditor shall document:*
- (a) *The overall audit strategy;*
 - (b) *The audit plan; and*
 - (c) *Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)*

Additional Considerations in Initial Audit Engagements

12. *The auditor shall undertake the following activities prior to starting an initial audit:*
- (a) *Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement⁴; and*
 - (b) *Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A21)*

Application and Other Explanatory Material

The Role and Timing of Planning (Ref: Para. 1)

A1. *Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:*

- *Helping the auditor to devote appropriate attention to important areas of the audit.*
- *Helping the auditor identify and resolve potential problems on a timely basis.*

⁴ SA 220, paragraphs 12-13.

- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

A2. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A3. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

A4. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

Involvement of Key Engagement Team Members (Ref: Para. 4)

A5. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process⁵.

Preliminary Engagement Activities (Ref: Para. 5)

A6. Performing the preliminary engagement activities specified in paragraph 5 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A7. Performing these preliminary engagement activities enables the auditor to plan an audit engagement

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10, establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 15 provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

I.196 Auditing Pronouncements

for which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

A8. The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the audit engagement as changes in conditions and circumstances occur. Performing initial procedures on both client continuance and evaluation of ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

Planning Activities

The Overall Audit Strategy (Ref: Para. 6-7)

A9. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
- When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

A10. The Appendix lists examples of considerations in establishing the overall audit strategy.

A11. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

Considerations Specific to Smaller Entities

A12. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 7.

The Audit Plan (Ref: Para. 8)

A13. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Changes to Planning Decisions During the Course of the Audit (Ref: Para. 9)

A14. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review (Ref: Para. 10)

A15. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- The capabilities and competence of the individual team members performing the audit work.

SA 220 contains further guidance on the direction, supervision and review of audit work⁶.

Considerations Specific to Smaller Entities

A16. When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body⁷.

Documentation (Ref: Para. 11)

A17. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the

⁶ SA 220, paragraphs 15-17.

⁷ In India, the Institute of Chartered Accountants of India governs the accountancy profession to provide services of high quality in the public interest which are accepted worldwide.

I.198 Auditing Pronouncements

auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A18. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A19. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Considerations Specific to Smaller Entities

A20. As discussed in paragraph A12, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs and/or checklists (see paragraph A18) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

Additional Considerations in Initial Audit Engagements (Ref: Para. 12)

A21. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (see SA 510⁸ "Initial Audit Engagements—Opening Balances").
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Modifications to ISA 300, "Planning an Audit of Financial Statements"

SA 300, "Planning an Audit of Financial Statements" does not contain any modifications *vis a vis* ISA 300.

⁸ SA 510, "Initial Audit Engagements—Opening Balances".

Appendix

(Ref: Para. 6-7 and A9-A12)

Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other SAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

I.200 Auditing Pronouncements

- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of materiality in accordance with SA 320⁹, and, where applicable:
 - Determination of materiality for components and communication thereof to component auditors.
 - Preliminary identification of significant components and material classes of transactions, account balances and disclosures
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

⁹ SA 320, "Materiality in Planning and Performing an Audit".

SA 315*

**Identifying and Assessing the Risk of Material
Misstatement through understanding the
Entity and its Environment**
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2008)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
- (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
- (c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
- (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

* Published in February, 2008 issue of the Journal.

I.202 Auditing Pronouncements

- (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A5)
6. The risk assessment procedures shall include the following:
 - (a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6)
 - (b) Analytical procedures. (Ref: Para. A7-A10)
 - (c) Observation and inspection. (Ref: Para. A11)
7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. Where the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A12-A13)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A14-A16)

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:
 - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17-A22)
 - (b) The nature of the entity, including:
 - (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A23-A27)
 - (c) The entity's selection and application of accounting policies, including the reasons for changes thereto.

The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A28)

- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29-A35)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A36-A41)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42-A65)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A66-A68)

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives;
- (b) Estimating the significance of the risks;
- (c) Assessing the likelihood of their occurrence; and
- (d) Deciding about actions to address those risks. (Ref: Para. A79)

16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant

I.204 Auditing Pronouncements

deficiency in internal control. (Ref: Para. A80)

The information system, including the related business processes, relevant to financial reporting, and communication.

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
- (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures;
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A81-A85)

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

- (a) Communications between management and those charged with governance; and
- (b) External communications, such as those with regulatory authorities. (Ref: Para. A86-A87)

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. (Ref: Para. A88-A94)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A95-A97)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)

23. If the entity has an internal audit function,¹ the auditor shall obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

- (a) The nature of the internal audit function's responsibilities and how the internal audit function fits in the

¹ SA 610, "Using the Work of Internal Auditors", paragraph 7(a).

entity's organisational structure; and

- (b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A101-A103)
24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A104)

Identifying and Assessing the Risks of Material Misstatement

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

- (a) the financial statement level; and (Ref: Para. A105-A108)
- (b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A109-A113)

to provide a basis for designing and performing further audit procedures.

26. For this purpose, the auditor shall:

- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114-A115)
- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116-A118)
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud;
- (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (c) The complexity of transactions;
- (d) Whether the risk involves significant transactions with related parties;
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119-A123)

29. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

I.206 Auditing Pronouncements

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A127-A129)

Revision of Risk Assessment

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A130)

Documentation

32. The auditor shall document:

- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- ◆ Assessing risks of material misstatement of the financial statements;
- ◆ Determining materiality in accordance with SA 320²;
- ◆ Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- ◆ Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;

² SA 320, "Materiality in Planning and Performing an Audit".

- ◆ Developing expectations for use when performing analytical procedures;
- ◆ Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- ◆ Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this SA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240³, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.

A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11-24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:

- ◆ Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
- ◆ Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management and Others Within the Entity (Ref: Para. 6(a))

A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- ◆ Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- ◆ Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- ◆ Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain

³ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraphs 12-24.

I.208 Auditing Pronouncements

accounting policies.

- ◆ Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- ◆ Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

Analytical Procedures (Ref: Para. 6(b))

A7. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks*. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A8. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A9. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

A10. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection (Ref: Para. 6(c))

A11. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- ◆ The entity's operations.
- ◆ Documents (such as business plans and strategies), records, and internal control manuals.
- ◆ Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- ◆ The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

A12. The auditor's previous experience with the entity and audit procedures performed in previous audits

* SA 520, "Analytical Procedures", paragraphs A1-A3 describe the nature of analytical procedures.

may provide the auditor with information about such matters as:

- ◆ Past misstatements and whether they were corrected on a timely basis.
- ◆ The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- ◆ Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A13. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team (Ref: Para. 10)

A14. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- ◆ Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- ◆ Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- ◆ Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.
- ◆ Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

SA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.⁴

A15. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A16. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material

⁴ SA 240, paragraph 15.

I.210 Auditing Pronouncements

misstatement due to fraud or error.

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

Industry factors

A17. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- ◆ The market and competition, including demand, capacity, and price competition.
- ◆ Cyclical or seasonal activity.
- ◆ Product technology relating to the entity's products.
- ◆ Energy supply and cost.

A18. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience⁵.

Regulatory factors

A19. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- ◆ Accounting principles and industry specific practices.
- ◆ Regulatory framework for a regulated industry.
- ◆ Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- ◆ Taxation (corporate and other).
- ◆ Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- ◆ Environmental requirements affecting the industry and the entity's business.

A20. SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"⁶, includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry.

A21. In case of the audits of certain entities, in addition to legislation or regulations, there may be government policy requirements and resolutions of the legislature that affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other external factors

A22. Examples of other external factors affecting the entity that the auditor may consider include the general

⁵ SA 220, "Quality Control for an Audit of Financial Statements", paragraph 14.

⁶ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", paragraph 10.

economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity (Ref: Para.11(b))

A23. An understanding of the nature of an entity enables the auditor to understand such matters as:

- ◆ Whether the entity has a complex structure, for example with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- ◆ The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately. SA 550, "Related Parties"⁷, establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A24. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- ◆ Business operations – such as:
 - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
 - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
 - Alliances, joint ventures, and outsourcing activities.
 - Geographic dispersion and industry segmentation.
 - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
 - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
 - Research and development activities and expenditures.
 - Transactions with related parties.
- ◆ Investments and investment activities – such as:
 - Planned or recently executed acquisitions or divestitures.
 - Investments and dispositions of securities and loans.
 - Capital investment activities.
 - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- ◆ Financing and financing activities – such as:
 - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.

⁷ SA 550, "Related Parties". Reference may also be made to the Accounting Standard (AS) 18, "Related Party Disclosures" for definition of related party and related party transactions.

I.212 Auditing Pronouncements

- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.
- ◆ Financial reporting – such as:
 - Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition practices.
 - Accounting for fair values.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A25. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A26. A special-purpose entity (sometimes referred to as a special purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitisation of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (e.g., as part of a de-recognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As SA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.⁸

A27. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special- purpose entity.

The Entity's Selection and Application of Accounting Policies (Ref: Para.11(c))

A28. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- ◆ The methods the entity uses to account for significant and unusual transactions.
- ◆ The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- ◆ Changes in the entity's accounting policies.
- ◆ Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref. Para.11(d))

⁸ SA 550, 'Related Parties', paragraph A7.

A29. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A30. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognise the need for change may also give rise to business risk. Business risk may arise, for example, from:

- ◆ The development of new products or services that may fail;
- ◆ A market which, even if successfully developed, is inadequate to support a product or service; or
- ◆ Flaws in a product or service that may result in liabilities and reputational risk.

A31. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A32. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- ◆ Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- ◆ New products and services (a potential related business risk might be, for example, that there is increased product liability).
- ◆ Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- ◆ New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- ◆ Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- ◆ Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- ◆ Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- ◆ The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A33. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in the

I.214 Auditing Pronouncements

Appendix 2.

A34. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A79-A80.

A35. In case of audits of certain entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, and government directions.

Measurement and Review of the Entity’s Financial Performance (Ref: Para. 11(e))

A36. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity’s performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud – See SA 240 for requirements and guidance in relation to the risks of fraud.

A37. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A98-A104), though their purposes may overlap:

- ◆ The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- ◆ Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

A38. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- ◆ Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- ◆ Period-on-period financial performance analyses.
- ◆ Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- ◆ Employee performance measures and incentive compensation policies.
- ◆ Comparisons of an entity’s performance with that of competitors.

A39. External parties may also measure and review the entity’s financial performance. For example, external information such as analysts’ reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A40. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations specific to smaller entities

A41. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control

A42. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures.

A43. The following application material on internal control is presented in four sections, as follows:

- ◆ General Nature and Characteristics of Internal Control.
- ◆ Controls Relevant to the Audit.
- ◆ Nature and Extent of the Understanding of Relevant Controls.
- ◆ Components of Internal Control.

General Nature and Characteristics of Internal Control (Ref: Para. 12)

Purpose of internal control

A44. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- ◆ The reliability of the entity's financial reporting;
- ◆ The effectiveness and efficiency of its operations;
- ◆ Its compliance with applicable laws and regulations; and
- ◆ Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

A45. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of internal control

A46. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A47. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

I.216 Auditing Pronouncements

A48. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A49. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager⁹ may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A50. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of internal control into components

A51. The division of internal control into the following five components, for purposes of the SAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

- (a) The control environment;
- (b) The entity's risk assessment process;
- (c) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this SA, provided all the components described in this SA are addressed.

A52. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A69-A104 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of manual and automated elements of internal control relevant to the auditor's risk assessment

A53. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A54. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- ◆ Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- ◆ Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent

⁹ Owner-manager refers to the proprietor of an entity who is involved in running the entity on a day-to-day basis.

of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A55. Generally, IT benefits an entity's internal control by enabling an entity to:

- ◆ Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- ◆ Enhance the timeliness, availability, and accuracy of information;
- ◆ Facilitate the additional analysis of information;
- ◆ Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- ◆ Reduce the risk that controls will be circumvented; and
- ◆ Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A56. IT also poses specific risks to an entity's internal control, including, for example:

- ◆ Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- ◆ Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- ◆ The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- ◆ Unauthorised changes to data in master files.
- ◆ Unauthorised changes to systems or programs.
- ◆ Failure to make necessary changes to systems or programs.
- ◆ Inappropriate manual intervention.
- ◆ Potential loss of data or inability to access data as required.

A57. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- ◆ Large, unusual or non-recurring transactions.
- ◆ Circumstances where errors are difficult to define, anticipate or predict.
- ◆ In changing circumstances that require a control response outside the scope of an existing automated control.
- ◆ In monitoring the effectiveness of automated controls.

A58. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

I.218 Auditing Pronouncements

- ◆ High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- ◆ Control activities where the specific ways to perform the control can be adequately designed and automated.

A59. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A60. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A61. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- ◆ Materiality.
- ◆ The significance of the related risk.
- ◆ The size of the entity.
- ◆ The nature of the entity's business, including its organisation and ownership characteristics.
- ◆ The diversity and complexity of the entity's operations.
- ◆ Applicable legal and regulatory requirements.
- ◆ The circumstances and the applicable component of internal control.
- ◆ The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- ◆ Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

A62. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A63. Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

A64. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight

schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

A65. In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A66. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A67. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- ◆ Inquiring of entity personnel.
- ◆ Observing the application of specific controls.
- ◆ Inspecting documents and reports.
- ◆ Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

A68. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A55), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in SA 330, "The Auditor's Responses to Assessed Risks".

Components of Internal Control—Control Environment (Ref: Para. 14)

A69. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A70. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) *Participation by those charged with governance* – Attributes of those charged with governance

I.220 Auditing Pronouncements

such as:

- ◆ Their independence from management.
 - ◆ Their experience and stature.
 - ◆ The extent of their involvement and the information they receive, and the scrutiny of activities.
 - ◆ The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) Management's philosophy and operating style – Characteristics such as management's:
- ◆ Approach to taking and managing business risks.
 - ◆ Attitudes and actions toward financial reporting.
 - ◆ Attitudes toward information processing and accounting functions and personnel.
- (e) *Organisational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) *Assignment of authority and responsibility* - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit evidence for elements of the control environment

A71. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

Effect of the control environment on the assessment of the risks of material misstatement

A72. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- ◆ Their independence from management and their ability to evaluate the actions of management.
- ◆ Whether they understand the entity's business transactions.
- ◆ The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.

A73. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

A74. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures¹⁰.

A75. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations specific to smaller entities

A76. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small business; it may, however, increase other risks, for example, the risk of override of controls.

A77. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

A78. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

A79. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations specific to smaller entities (Ref: Para. 17)

A80. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Components of Internal Control—The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

The information system, including related business processes, relevant to financial reporting (Ref: Para. 18)

A81. The information system relevant to financial reporting objectives, which includes the accounting

¹⁰ SA 330, paragraphs A2-A3.

I.222 Auditing Pronouncements

system, consists of the procedures and records designed and established to:

- ◆ Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- ◆ Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- ◆ Process and account for system overrides or bypasses to controls;
- ◆ Transfer information from transaction processing systems to the general ledger;
- ◆ Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of accounts receivables; and
- ◆ Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarised and appropriately reported in the financial statements.

Journal entries

A82. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A83. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

A84. An entity's business processes are the activities designed to:

- ◆ Develop, purchase, produce, sell and distribute an entity's products and services;
- ◆ Ensure compliance with laws and regulations; and
- ◆ Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities

A85. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains

important.

Communication (Ref: Para. 19)

A86. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A87. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities (Ref: Para. 20)

A88. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

- ◆ Authorization.
- ◆ Performance reviews.
- ◆ Information processing.
- ◆ Physical controls.
- ◆ Segregation of duties.

A89. Control activities that are relevant to the audit are:

- ◆ Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- ◆ Those that are considered to be relevant in the judgment of the auditor.

A90. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A91. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A92. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations specific to smaller entities

A93. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of

I.224 Auditing Pronouncements

control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A94. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks arising from IT (Ref: Para. 21)

A95. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT-controls and application controls.

A96. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- ◆ Data center and network operations.
- ◆ System software acquisition, change and maintenance.
- ◆ Program change.
- ◆ Access security.
- ◆ Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A56 above.

A97. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

A98. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A99. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations specific to smaller entities

A100. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Internal Audit Functions (Ref: Para 23)

A101. The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 applies.

A102. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting.

A103. If the nature of the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed, or to be performed by, the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

Sources of information (Ref: Para. 24)

A104. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- ◆ the sources of the information related to the entity's monitoring activities; and
- ◆ the basis upon which management considers the information to be sufficiently reliable for the purpose; is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25 (a))

A105. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A106. Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A107. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- ◆ Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is

I.226 Auditing Pronouncements

such that an audit cannot be conducted.

- ◆ Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

A108.SA 705, "Modifications to the Opinion in the Independent Auditor's Report" establishes requirements and provides guidance in determining whether there is a need for the auditor to consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement where this is legally possible.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A109.Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A110.In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

A111.Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

- (a) Assertions about classes of transactions and events for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
 - (v) Classification—transactions and events have been recorded in the proper accounts.
- (b) Assertions about account balances at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
 - (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- (c) Assertions about presentation and disclosure:
 - (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have

occurred and pertain to the entity.

- (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
- (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
- (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

A112. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

A113. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph A111, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A114. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

A115. **Appendix 2** provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions [Ref: Para. 26(c)]

A116. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A117. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A118. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A119. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine

I.228 Auditing Pronouncements

transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A120. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- ◆ Greater management intervention to specify the accounting treatment.
- ◆ Greater manual intervention for data collection and processing.
- ◆ Complex calculations or accounting principles.
- ◆ The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A121. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- ◆ Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- ◆ Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A122. SA 330 describes the consequences for further audit procedures of identifying a risk as significant.¹¹

Significant risks relating to the risks of material misstatement due to fraud

A123. SA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.¹²

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A124. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- ◆ Control activities such as a review of assumptions by senior management or experts.
- ◆ Documented processes for estimations.
- ◆ Approval by those charged with governance.

A125. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A126. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to

¹¹ SA 330, paragraphs 15 and 21.

¹² SA 240, paragraph 25-27.

implement such controls is an indicator of a significant deficiency in internal control.¹³

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence
(Ref: Para. 30)

A127. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A128. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- ◆ Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- ◆ The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

A129. The consequences for further audit procedures of identifying such risks are described in SA 330.¹⁴

Revision of Risk Assessment (Ref: Para. 31)

A130. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See SA 330 for further guidance.

Documentation (Ref: Para. 32)

A131. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan that is required by SA 300, "Planning an Audit of Financial Statements"¹⁵. Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see SA 330)¹⁶. The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A132. For entities that have uncomplicated businesses and processes relevant to financial reporting, the

¹³ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Paragraph A7.

¹⁴ SA 330, paragraph 8.

¹⁵ SA 300, paragraphs 7 and 9.

¹⁶ SA 330, paragraph 8.

I.230 Auditing Pronouncements

documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A133. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of SA 230, "Audit Documentation" are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A134. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

Material Modifications to ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Deletions

1. Paragraph A21 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the effect of ministerial directives, government policy requirements and resolutions of the legislature on the operations of the entity. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the operation of the entity may be affected by government policy requirements and resolutions of the legislature. Accordingly, the spirit of erstwhile A21, highlighting the fact that in some cases, the entity's operations may be affected by such requirements/resolutions, has been retained.

2. Paragraph A35 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the influence of concerns relating to public accountability, including objectives having source in legislation, regulations, government ordinances, etc., on 'management objectives'. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the management's objectives are influenced by such aspects. Accordingly, the spirit of erstwhile A35, highlighting the fact that in some cases, the management objectives may be influenced by the concerns relating to public accountability, including objectives having source in legislation, regulations, government directions, has been retained.

3. Paragraph A65 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the additional reporting responsibilities of the auditor with respect to internal control because of any code of practice or compliance with legislative authorities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the statute or regulations may require the auditor to report on compliance with certain specific aspects of internal control. Accordingly, the spirit of erstwhile A65, highlighting such additional reporting responsibilities of the auditor, has been retained.

4. Paragraph A113 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the relevance of management's assertions that transactions and events have been carried out in accordance with legislation or proper authority, for the financial statement audit. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be similar assertions made by the management that may fall within the scope of the financial statement audit. Accordingly, the spirit of erstwhile A113, highlighting such fact, has been retained and an example has been added.

Appendix 1

(Ref: Paras. 4(c), 14-23 and A65-A97)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14-24 and A69-A104, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:
 - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
 - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
 - (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
 - (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
 - (e) *Organizational structure.* Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.
 - (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.
 - (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars

illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
 - ◆ *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
 - ◆ *New personnel.* New personnel may have a different focus on or understanding of internal control.
 - ◆ *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
 - ◆ *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
 - ◆ *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
 - ◆ *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
 - ◆ *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
 - ◆ *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
 - ◆ *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant To Financial Reporting, And Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

I.234 Auditing Pronouncements

6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
 - ◆ Identify and record all valid transactions.
 - ◆ Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
 - ◆ Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
 - ◆ Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
 - ◆ Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:
 - ◆ *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
 - ◆ *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
 - ◆ *Physical controls.* Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting

records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

- ◆ *Segregation of duties.* Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.
10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.
13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A29 and A108)

Conditions and Events that May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- ◆ Operations in regions that are economically unstable, for example, countries with significant currency

I.236 Auditing Pronouncements

devaluation or highly inflationary economies.

- ◆ Operations exposed to volatile markets, for example, futures trading.
- ◆ Operations that are subject to a high degree of complex regulation.
- ◆ Going concern and liquidity issues including loss of significant customers.
- ◆ Constraints on the availability of capital and credit.
- ◆ Changes in the industry in which the entity operates.
- ◆ Changes in the supply chain.
- ◆ Developing or offering new products or services, or moving into new lines of business.
- ◆ Expanding into new locations.
- ◆ Changes in the entity such as large acquisitions or reorganisations or other unusual events.
- ◆ Entities or business segments likely to be sold.
- ◆ The existence of complex alliances and joint ventures.
- ◆ Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- ◆ Significant transactions with related parties.
- ◆ Lack of personnel with appropriate accounting and financial reporting skills.
- ◆ Changes in key personnel including departure of key executives.
- ◆ Deficiencies in internal control, especially those not addressed by management.
- ◆ Inconsistencies between the entity's IT strategy and its business strategies.
- ◆ Changes in the IT environment.
- ◆ Installation of significant new IT systems related to financial reporting.
- ◆ Inquiries into the entity's operations or financial results by regulatory or government bodies.
- ◆ Past misstatements, history of errors or a significant amount of adjustments at period end.
- ◆ Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- ◆ Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- ◆ Application of new accounting pronouncements.
- ◆ Accounting measurements that involve complex processes.
- ◆ Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- ◆ Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

SA 320*

Materiality in Planning and Performing an Audit (Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450¹, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
 - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
 - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
 - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.² The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

* Published in August, 2009 issue of the Journal.

¹ SA 450, "Evaluation of Misstatements Identified during the Audit".

² For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".

I.238 Auditing Pronouncements

- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
 - (b) Understand that financial statements are prepared, presented and audited to levels of materiality;
 - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
 - (d) Make reasonable economic decisions on the basis of the information in the financial statements.
5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)
6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
- (a) Determining the nature, timing and extent of risk assessment procedures;
 - (b) Identifying and assessing the risks of material misstatement; and
 - (c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.³

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

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

Definition

9. For purposes of the SAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence

³ SA 450, paragraph A16.

the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)
13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:
 - (a) Materiality for the financial statements as a whole (see paragraph 10);
 - (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);
 - (c) Performance materiality (see paragraph 11); and
 - (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

- A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.⁴ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level⁵. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk⁶. Materiality and audit risk are considered throughout the audit, in particular, when:
 - (a) Identifying and assessing the risks of material misstatement⁷;

⁴ SA 200, paragraph 11.

⁵ SA 200, paragraph 17.

⁶ SA 200, paragraph 13(c)

⁷ SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".

I.240 Auditing Pronouncements

- (b) Determining the nature, timing and extent of further audit procedures⁸; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report⁹.

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

- A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:
- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
 - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
 - The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
 - The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
 - The relative volatility of the benchmark.
- A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
- A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.
- A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.
- A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional

⁸ SA 330, "The Auditor's Responses to Assessed Risks".

⁹ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

- A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.
- A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .
- A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures
(Ref: Para. 10)

- A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:
- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
 - The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
 - Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).
- A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

- A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which,

I.242 Auditing Pronouncements

as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

- A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.

2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may be an appropriate benchmark. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained.

SA 330*
The Auditor's
Responses to Assessed Risks
(Effective for audits of financial statements
for periods beginning on or after April 1, 2008)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315, "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment" in a financial statement audit.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective

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

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

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

Requirements

Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

7. In designing the further audit procedures to be performed, the auditor shall:

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I.244 Auditing Pronouncements

- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
 - (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9-A18)
- (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

Tests of Controls

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:
- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
 - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20-A24)
9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

Nature and Extent of Tests of Controls

10. In designing and performing tests of controls, the auditor shall:
- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit.
 - (ii) The consistency with which they were applied.
 - (iii) By whom or by what means they were applied. (Ref: Para. A26-A29)
 - (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30-A31)

Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

Using audit evidence obtained during an interim period

12. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:
- (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and
 - (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of

controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
- (c) The effectiveness of general IT-controls;
- (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)

14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

- (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)
- (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-A39)

Controls over significant risks

15. When the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)

17. When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

- (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- (b) Additional tests of controls are necessary; or
- (c) The potential risks of misstatement need to be addressed using substantive procedures. (Ref: Para. A41)

Substantive Procedures

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42-A47)

I.246 Auditing Pronouncements

19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48-A51)

Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- (a) Agreeing or reconciling the financial statements with the underlying accounting records; and
- (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

Substantive Procedures Responsive to Significant Risks

21. When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

Timing of Substantive Procedures (Ref: Para.A54)

22. When substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

- (a) substantive procedures, combined with tests of controls for the intervening period; or
- (b) if the auditor determines that it is sufficient, further substantive procedures only;

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A55-A57)

23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

Adequacy of Presentation and Disclosure

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60-A61)

26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)

27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or a disclaimer of opinion.

Documentation

28. The auditor shall document:

- (a) The overall responses to address the assessed risks of material misstatement at the financial

statement level, and the nature, timing and extent of the further audit procedures performed;

- (b) The linkage of those procedures with the assessed risks at the assertion level; and
- (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)

29. If the auditor plans to use audit evidences about the operating effectiveness of controls obtained in previous audits, the auditor shall document the conclusions reached about relying on such controls that were tested in a previous audit.

30. The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

Application and Other Explanatory Material

Overall Responses (Ref: Para. 5)

A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, (as

I.248 Auditing Pronouncements

appropriate and notwithstanding the requirements of this SA)¹, the auditor may determine that:

- (a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;
- (b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or
- (c) A combined approach using both tests of controls and substantive procedures is an effective approach.

A5. The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedure) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditors' further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

Timing

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may

¹ For example, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each significant class of transactions, account balance, and disclosure.

decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing the financial statements to the accounting records;
- Examining adjustments made during the course of preparing the financial statements; and
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalised.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A17. In certain circumstances, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity

I.250 Auditing Pronouncements

may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para 7(b))

A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, e.g., by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

Tests of Controls

Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, as discussed in SA 315, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level². This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

² SA 315, paragraph 30.

Audit Evidence and Intended Reliance (Ref: Para. 9)

A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 10(a))

A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

SA 530, "Audit Sampling" contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorised version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the

I.252 Auditing Pronouncements

case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorised access has not occurred during the period.

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT-controls) are described as "indirect" controls.

A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using audit evidence obtained during an interim period (Ref: Para. 12)

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para.13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

- (a) Have not changed since they were last tested; and
- (b) Are not controls that mitigate a significant risk;

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT-controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para.16-17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that: (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (ii) there are inherent limitations to internal control, including management override.

Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See SA 500³.

Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.

³ SA 500, "Audit Evidence", paragraph 10.

- Accounts payable balances and terms.

A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
 - May not accept responsibility for responding to a confirmation request;
 - May consider responding too costly or time consuming;
 - May have concerns about the potential legal liability resulting from responding;
 - May account for transactions in different currencies; or
 - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20(b))

A52. The nature, and also the extent, of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 21)

A53. Paragraph 21 of this SA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In

I.256 Auditing Pronouncements

addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures (Ref: Para. 22-23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, e.g., a legal opinion obtained in a previous audit related to the structure of a securitisation to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

- (a) Identify amounts that appear unusual;
- (b) Investigate any such amounts; and
- (c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other relevant controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analysing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
 - (a) Significant unusual transactions or entries (including those at or near the period end);
 - (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
 - (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

Adequacy of Presentation and Disclosure (Ref: Para. 24)

A59. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25-27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognised risk of material misstatement.

In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. SA 315 contains further guidance on revising the auditor's risk assessment⁴.

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.

⁴ SA 315, paragraph 31.

I.258 Auditing Pronouncements

- Understanding of the entity and its environment, including the entity's internal control.

Documentation (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

Material Modifications to ISA 330, The Auditor's Responses to Assessed Risks

Deletion

1. Paragraph A17 of the Application Section of ISA 330 dealt with the application of the requirements of ISA 330 to the audits of public sector entities regarding the auditor's consideration of the nature, timing and extent of further audit procedures. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non-public sector entities the auditor may be required to give special considerations regarding the nature, timing and extent as a result of the terms of appointment of the auditor or any other special reporting requirement under the statute or regulation under which the entity operates. Accordingly, the spirit of erstwhile A17, highlighting the fact that in some cases, the auditor's consideration of the nature, timing and extent of further audit procedures may be affected by the audit mandate or any other special auditing requirements, has been retained.

SA 402*

**Audit Considerations relating to an Entity Using a
Service Organisation**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315¹ and SA 330² in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.
2. Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.
3. Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:
 - (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
 - (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
 - (d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;

* Published in August, 2009 issue of the Journal.

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

² SA 330, "The Auditor's Responses to Assessed Risks".

I.260 Auditing Pronouncements

- (e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.
4. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.
5. This SA does not apply to services provided by financial institutions that are limited to processing, for an entity's account held at the financial institution, transactions that are specifically authorised by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this SA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

Effective Date

6. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

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

Definitions

8. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) *Complementary user entity controls* – Controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.
 - (b) *Report on the description and design of controls at a service organisation (referred to in this SA as a Type 1 report)* – A report that comprises:
 - (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and
 - (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
 - (c) *Report on the description, design, and operating effectiveness of controls at a service organisation (referred to in this SA as a Type 2 report)* – A report that comprises:
 - (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

- (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:
 - a. The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
 - b. A description of the service auditor's tests of the controls and the results thereof.
- (d) *Service auditor* – An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.
- (e) *Service organisation* – A third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.
- (f) *Service organisation's system* – The policies and procedures designed, implemented and maintained by the service organisation to provide user entities with the services covered by the service auditor's report.
- (g) *Subservice organisation* – A service organisation used by another service organisation to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.
- (h) *User auditor* – An auditor who audits and reports on the financial statements of a user entity.
- (i) *User entity* – An entity that uses a service organisation and whose financial statements are being audited.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

9. When obtaining an understanding of the user entity in accordance with SA 315,³ the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: (Ref: Para. A1-A2)

- (a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control; (Ref: Para. A3-A5)
- (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation; (Ref: Para. A6)
- (c) The degree of interaction between the activities of the service organisation and those of the user entity; and (Ref: Para. A7)
- (d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation. (Ref: Para. A8-A11)

10. When obtaining an understanding of internal control relevant to the audit in accordance with SA 315,⁴ the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. (Ref: Para. A12-A14)

³ SA 315, paragraph 11.

⁴ SA 315, paragraph 12.

I.262 Auditing Pronouncements

11. The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.
12. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: (Ref: Para. A15-A20)
 - (a) Obtaining a Type 1 or Type 2 report, if available;
 - (b) Contacting the service organisation, through the user entity, to obtain specific information;
 - (c) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or
 - (d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation

13. In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: (Ref: Para. A21)
 - (a) The service auditor's professional competence (except where the service auditor is a member of the Institute of Chartered Accountants of India) and independence from the service organisation; and
 - (b) The adequacy of the standards under which the Type 1 or Type 2 report was issued.
14. If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall: (Ref: Para. A22-A23)
 - (a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;
 - (b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and
 - (c) Determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Responding to the Assessed Risks of Material Misstatement

15. In responding to assessed risks in accordance with SA 330 , the user auditor shall: (Ref: Para. A24-A28)
 - (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,
 - (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Tests of Controls

16. When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating

effectiveness of those controls from one or more of the following procedures: (Ref: Para. A29-A30)

- (a) Obtaining a Type 2 report, if available;
- (b) Performing appropriate tests of controls at the service organisation; or
- (c) Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively

17. If, in accordance with paragraph 16(a), the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by: (Ref: Para. A31-A39)
- (a) Evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;
 - (b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;
 - (c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
 - (d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation

18. If the user auditor plans to use a Type 1 or a Type 2 report that excludes the services provided by a subservice organisation and those services are relevant to the audit of the user entity's financial statements, the user auditor shall apply the requirements of this SA with respect to the services provided by the subservice organisation. (Ref: Para. A40)

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation

19. The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: Para. A41)

Reporting by the User Auditor

20. The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705⁵ if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements. (Ref: Para. A42)
21. The user auditor shall not refer to the work of a service auditor in the user auditor's report

⁵ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 6.

I.264 Auditing Pronouncements

containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A43)

22. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A44)

Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

Sources of Information (Ref: Para. 9)

- A1. Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as:
- User manuals.
 - System overviews.
 - Technical manuals.
 - The contract or service level agreement between the user entity and the service organisation.
 - Reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation.
 - Reports by the service auditor, including management letters, if available.
- A2. Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardised.

Nature of the Services Provided by the Service Organisation (Ref: Para. 9(a))

- A3. A user entity may use a service organisation such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organisations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.
- A4. Examples of service organisation services that are relevant to the audit include:
- Maintenance of the user entity's accounting records.
 - Management of assets.
 - Initiating, recording or processing transactions as agent of the user entity.

Considerations Specific to Smaller Entities

- A5. Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (e.g., payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organisation for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial

statements.⁶

Nature and Materiality of Transactions Processed by the Service Organisation (Ref: Para. 9(b))

A6. A service organisation may establish policies and procedures that affect the user entity's internal control. These policies and procedures are at least in part physically and operationally separate from the user entity. The significance of the controls of the service organisation to those of the user entity depends on the nature of the services provided by the service organisation, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

The Degree of Interaction between the Activities of the Service Organisation and the User Entity (Ref: Para. 9(c))

A7. The significance of the controls of the service organisation to those of the user entity also depends on the degree of interaction between its activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organisation initiates or initially records, processes, and does the accounting for the user entity's transactions, there is a lower degree of interaction between the two organisations. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions at the user entity and may rely on controls at the service organisation.

Nature of the Relationship between the User Entity and the Service Organisation (Ref: Para. 9(d))

A8. The contract or service level agreement between the user entity and the service organisation may provide for matters such as:

- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organisation;
- The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
- The indemnification, if any, to be provided to the user entity in the event of a performance failure;
- Whether the service organisation will provide a report on its controls and, if so, whether such report would be a Type 1 or Type 2 report;
- Whether the user auditor has rights of access to the accounting records of the user entity maintained by the service organisation and other information necessary for the conduct of the audit; and
- Whether the agreement allows for direct communication between the user auditor and the service auditor.

⁶ SA 200, paragraph 4 and A2-A3.

- A9. There is a direct relationship between the service organisation and the user entity and between the service organisation and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organisation. A direct relationship may also be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may use a service auditor to perform procedures on the user auditor's behalf, such as:
- (a) Tests of controls at the service organisation; or
 - (b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organisation.
- A10. Auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example when the service organisation is located in a different jurisdiction. In such situations, the auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained. In such cases, the auditor may also obtain or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organisation.
- A11. In the above context, the auditors may also use another auditor to perform tests of controls or substantive procedures in relation to compliance with law, regulation or other authority.

Understanding the Controls relating to Services provided by the Service Organisation (Ref: Para. 10)

- A12. The user entity may establish controls over the service organisation's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organisation. If a user entity, for example, uses a service organisation to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. These controls may include:
- Comparing the data submitted to the service organisation with reports of information received from the service organisation after the data has been processed.
 - Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.
- A13. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.
- A14. As noted in SA 315,7 in respect of some risks, the user auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organisations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of

⁷ SA 315, paragraph 30.

this SA.

Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity
(Ref: Para. 12)

A15. The user auditor's decision as to which procedure, individually or in combination, in paragraph 12 to undertake, in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement in relation to the user entity's use of the service organisation, may be influenced by such matters as:

- The size of both the user entity and the service organisation;
- The complexity of the transactions at the user entity and the complexity of the services provided by the service organisation;
- The location of the service organisation (for example, the user auditor may decide to use another auditor to perform procedures at the service organisation on the user auditor's behalf if the service organisation is in a remote location);
- Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence; and
- The nature of the relationship between the user entity and the service organisation.

A16. A service organisation may engage a service auditor to report on the description and design of its controls (Type 1 report) or on the description and design of its controls and their operating effectiveness (Type 2 report). Type 1 or Type 2 reports may be issued under Standard on Assurance Engagements (SAE) 34028 or under standards established by an authorised or recognised standards setting organisation (which may identify them by different names, such as Type A or Type B reports).

A17. The availability of a Type 1 or Type 2 report will generally depend on whether the contract between a service organisation and a user entity includes the provision of such a report by the service organisation. A service organisation may also elect, for practical reasons, to make a Type 1 or Type 2 report available to the user entities. However, in some cases, a Type 1 or Type 2 report may not be available to user entities.

A18. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organisations. As a report on controls at the service organisation may not be available in these circumstances, visiting the service organisation may be the most effective procedure for the user auditor to gain an understanding of controls at the service organisation, as there is likely to be direct interaction of management of the user entity with management at the service organisation.

A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organisation. If a Type 1 or Type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organisation. The user auditor using the work of another auditor may find the guidance in SA 600⁹ useful as it relates to understanding another auditor

⁸ SAE 3402, Assurance Reports on Controls at a Service Organisation.

⁹ SA 600, Using the Work of Another Auditor.

(including that auditor's independence and professional competence¹⁰), involvement in the work of another auditor in planning the nature, extent and timing of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.

A20. A user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation. A user auditor may need to consider controls at the sub-service organisation. In situations where one or more sub-service organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the sub-service organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the sub-service organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation's and sub-service organisation's controls to the user entity's controls.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation (Ref: Para. 13-14)

A21. The user auditor may make inquiries about the service auditor to the service auditor's professional organisation or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organisation, and the user auditor may obtain information about the standards used by the service auditor from the standard setting organisation.

A22. A Type 1 or Type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of:

- (a) The aspects of controls at the service organisation that may affect the processing of the user entity's transactions, including the use of subservice organisations;
- (b) The flow of significant transactions through the service organisation to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;
- (c) The control objectives at the service organisation that are relevant to the user entity's financial statement assertions; and
- (d) Whether controls at the service organisation are suitably designed and implemented to prevent or detect processing errors that could result in material misstatements in the user entity's financial statements.

A Type 1 or Type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

A23. A Type 1 or Type 2 report that is as of a date or for a period that is outside of the reporting period of a user entity may assist the user auditor in obtaining a preliminary understanding of the controls implemented at the service organisation if the report is supplemented by additional current information from other sources. If the service organisation's description of controls is as of

¹⁰ Except where such other auditor is a member of the Institute of Chartered Accountants of India.

a date or for a period that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a Type 1 or Type 2 report, such as:

- Discussing the changes at the service organisation with user entity personnel who would be in a position to know of such changes;
- Reviewing current documentation and correspondence issued by the service organisation; or
- Discussing the changes with service organisation personnel.

Responding to the Assessed Risks of Material Misstatement (Ref: Para. 15)

A24. Whether the use of a service organisation increases a user entity's risk of material misstatement depends on the nature of the services provided and the controls over these services; in some cases, the use of a service organisation may decrease a user entity's risk of material misstatement, particularly if the user entity itself does not possess the expertise necessary to undertake particular activities, such as initiating, processing, and recording transactions, or does not have adequate resources (e.g., an IT system).

A25. When the service organisation maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organisation's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may thereby obtain evidence as to the adequacy of controls operated by the service organisation over the completeness and integrity of the user entity's data for which the service organisation is responsible.

A26. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organisation on behalf of the user entity, the following procedures may be considered by the user auditor:

- (a) Inspecting records and documents held by the user entity: the reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases, the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.
- (b) Inspecting records and documents held by the service organisation: the user auditor's access to the records of the service organisation may be established as part of the contractual arrangements between the user entity and the service organisation. The user auditor may also use another auditor, on its behalf, to gain access to the user entity's records maintained by the service organisation.
- (c) Obtaining confirmations of balances and transactions from the service organisation: where the user entity maintains independent records of balances and transactions, confirmation from the service organisation corroborating the user entity's records may constitute reliable audit evidence concerning the existence of the transactions and assets concerned. For example, when multiple service organisations are used, such as an investment manager and a custodian, and these service organisations maintain independent records, the user auditor may confirm balances with these organisations in order to compare this information with the independent records of the user entity.

If the user entity does not maintain independent records, information obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable

I.270 Auditing Pronouncements

audit evidence. In these circumstances, the user auditor may consider whether an alternative source of independent evidence can be identified.

- (d) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organisation: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.
- A27. Another auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by another auditor, of procedures agreed upon by the user entity and its user auditor and by the service organisation and its service auditor. The findings resulting from the procedures performed by another auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organisation may be used by user auditors as part of the evidence necessary to support their audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to agree, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.
- A28. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organisation, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organisation. Substantive procedures may need to be performed at the service organisation by the user auditor or another auditor on its behalf. A service auditor may provide a Type 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. The involvement of another auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by another auditor.

Tests of Controls (Ref: Para. 16)

- A29. The user auditor is required by SA 330¹¹ to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls in certain circumstances. In the context of a service organisation, this requirement applies when:
- (a) The user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organisation are operating effectively (i.e., the user auditor intends to rely on the operating effectiveness of controls at the service organisation in determining the nature, timing and extent of substantive procedures); or
 - (b) Substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.
- A30. If a Type 2 report is not available, a user auditor may contact the service organisation, through the user entity, to request that a service auditor be engaged to provide a Type 2 report that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform procedures at the service organisation that test the operating effectiveness of those controls. A user

¹¹ SA 330, paragraph 8.

auditor may also visit the service organisation and perform tests of relevant controls if the service organisation agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the work of another auditor and the user auditor's own procedures.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively (Ref: Para. 17)

A31. A Type 2 report may be intended to satisfy the needs of several different user auditors; therefore tests of controls and results described in the service auditor's report may not be relevant to assertions that are significant in the user entity's financial statements. The relevant tests of controls and results are evaluated to determine that the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

- (a) The time period covered by the tests of controls and the time elapsed since the performance of the tests of controls;
- (b) The scope of the service auditor's work and the services and processes covered, the controls tested and tests that were performed, and the way in which tested controls relate to the user entity's controls; and
- (c) The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

A32. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the Type 2 report to the user entity's financial reporting period, the user auditor may conclude that the Type 2 report offers less audit evidence if there is little overlap between the period covered by the Type 2 report and the period for which the user auditor intends to rely on the report. When this is the case, a Type 2 report covering a preceding or subsequent period may provide additional audit evidence. In other cases, the user auditor may determine it is necessary to perform, or use another auditor to perform, tests of controls at the service organisation in order to obtain sufficient appropriate audit evidence about the operating effectiveness of those controls.

A33. It may also be necessary for the user auditor to obtain additional evidence about significant changes to the relevant controls at the service organisation outside of the period covered by the Type 2 report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain about controls at the service organisation that were operating outside of the period covered by the service auditor's report may include:

- The significance of the assessed risks of material misstatement at the assertion level;
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel;
- The degree to which audit evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period;
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls; and
- The effectiveness of the control environment and monitoring of controls at the user entity.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the

I.272 Auditing Pronouncements

remaining period or testing the user entity's monitoring of controls.

- A35. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.
- A36. In certain circumstances, a service provided by the service organisation may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorising transactions before they are sent to the service organisation for processing. In such a situation, the service organisation's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are relevant to the service provided to the user entity.
- A37. If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organisation, through the user entity, to request a discussion with the service auditor about the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organisation, through the user entity, to request that the service auditor perform procedures at the service organisation. Alternatively, the user auditor, or another auditor at the request of the user auditor, may perform such procedures.
- A38. The service auditor's Type 2 report identifies results of tests, including exceptions and other information that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's Type 2 report do not automatically mean that the service auditor's Type 2 report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's Type 2 report are considered in the user auditor's assessment of the testing of controls performed by the service auditor. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may discuss such matters with the service auditor. Such communication is dependent upon the user entity contacting the service organisation, and obtaining the service organisation's approval for the communication to take place.

Communication of Deficiencies in Internal Control identified during the Audit

- A39. The user auditor is required to communicate in writing significant deficiencies identified during the audit to both management and those charged with governance on a timely basis.¹² The user auditor is also required to communicate to management at an appropriate level of responsibility on a timely basis other deficiencies in internal control identified during the audit that, in the user auditor's professional judgment, are of sufficient importance to merit management's attention.¹³ Matters that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include:

- Any monitoring of controls that could be implemented by the user entity, including those identified as a result of obtaining a Type 1 or Type 2 report;

¹² SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9 and 10.

¹³ SA 265, paragraph 9.

- Instances where complementary user entity controls are noted in the Type 1 or Type 2 report and are not implemented at the user entity; and
- Controls that may be needed at the service organisation that do not appear to have been implemented or that are not specifically covered by a Type 2 report.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation (Ref: Para. 18)

A40. If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method, respectively. If the Type 1 or Type 2 report excludes the controls at a subservice organisation, and the services provided by the subservice organisation are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this SA in respect of the subservice organisation. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph 9 assists the user auditor in determining the effect of the subservice organisation and the nature and extent of work to be performed.

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation (Ref: Para. 19)

A41. A service organisation may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organisation's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organisation has reported any such matters and evaluates whether any matters reported by the service organisation affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may request the user entity to contact the service organisation to obtain the necessary information.

Reporting by the User Auditor (Ref: Para. 20)

A42. When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when:

- The user auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for the identification and assessment of the risks of material misstatement;
- A user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- Sufficient appropriate audit evidence is only available from records held at the service organisation, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or

I.274 Auditing Pronouncements

pervasive.

Reference to the Work of a Service Auditor (Ref: Para. 21-22)

- A43. In some cases, law or regulation may require a reference to the work of a service auditor in the user auditor's report, for example, for the purposes of transparency in the public sector. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.
- A44. The fact that a user entity uses a service organisation does not alter the user auditor's responsibility under SAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's report, the user auditor is not precluded from referring to the service auditor's report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

Material Modifications to ISA 402, "Audit Considerations Relating to an Entity Using a Service Organisation"

1. Paragraphs A10 and A11 of ISA 402 deal with the application of the requirements of ISA 402 to public sector auditors who have broad rights of access established by legislation. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

However, since the situation envisaged in paragraphs A10 and A11 may be possible even in case of auditors of non-public sector entities, the spirit of paragraphs A10 and A11 has been retained and made generic.
2. Paragraph 13 (a) and paragraph A19 of ISA 402 deal with assessment of the service auditor's professional competence and independence from the service organisation for obtaining sufficient and appropriate audit evidence and for reporting purposes. The corresponding paragraphs of SA 402 also require such assessment of professional competence except where the service auditor is also a member of the Institute of Chartered Accountants of India.

SA 450*

**Evaluation of Misstatements Identified during the
Audit**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised)¹ deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320² deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to evaluate:
 - (a) The effect of identified misstatements on the audit; and
 - (b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

* Published in August, 2009 issue of the Journal.

¹ 700, "Forming an Opinion and Reporting on Financial Statements", paragraphs 10-11.

² SA 320, "Materiality in Planning and Performing an Audit".

I.276 Auditing Pronouncements

- (b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

- 5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

Consideration of Identified Misstatements as the Audit Progresses

- 6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:
 - (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)
 - (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320. (Ref: Para. A5)
- 7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

Communication and Correction of Misstatements

- 8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation³. The auditor shall request management to correct those misstatements. (Ref: Para. A7-A9)
- 9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A 10)

Evaluating the Effect of Uncorrected Misstatements

- 10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)
- 11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
 - (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20)
 - (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)

³ SA 260, "Communication with Those Charged with Governance", paragraph A4.

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance⁴ uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)
13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representation

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The audit documentation shall include: (Ref: Para. A25)
 - (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
 - (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5,8 and 12); and
 - (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. (paragraph 11)

Application and Other Explanatory Material

Misstatements (Ref: Para. 4(a))

- A1. Misstatements may result from:
 - (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
 - (b) An omission of an amount or disclosure;
 - (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and
 - (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in SA 240.⁵

Accumulation of Identified Misstatements (Ref: Para. 5)

- A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another

⁴ In accordance with the paragraph 9 of SA 260, "Communication with Those Charged with Governance," if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

⁵ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.

I.278 Auditing Pronouncements

expression for “not material”. Matters that are “clearly trivial” will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

- A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
- Factual misstatements are misstatements about which there is no doubt.
 - Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
 - Projected misstatements are the auditor’s best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530⁶.

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

- A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.
- A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320, there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.⁷
- A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor’s projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

- A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A8. Law or regulation may restrict the auditor’s communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor’s obligations of

⁶ SA 530, “Audit Sampling”, paragraphs 14-15.

⁷ SA 530, paragraphs 5(c) and (d).

confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

- A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
- A10. SA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments⁸, which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

- A11. The auditor's determination of the materiality in accordance with SA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 based on the actual financial results.
- A12. SA 320 explains that, as the audit progresses, the materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially⁹. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with SA 320 (see paragraph 10 of this SA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures, are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.
- A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate¹⁰.
- A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels

⁸ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

⁹ SA 320, paragraph 12.

¹⁰ The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to re-assess the risk of material misstatement for that account balance or class of transactions.

applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Makes a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. SA 720¹¹ deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

¹¹ SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".

- A17. SA 24012, explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.
- A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.
- A19. In the case of an audit of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.
- A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

Communication with Those Charged with Governance (Ref: Para. 12)

- A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.¹³
- A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.
- A23. SA 260 requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this SA).¹⁴ The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representation (Ref: Para. 14)

- A24. Because management and, where appropriate, those charged with governance are responsible for adjusting the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We do not agree that itemsand constitute misstatements because [*description of reasons*]." Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

- A25. The auditor's documentation of uncorrected misstatements may take into account:

¹² SA 240, paragraph 35.

¹³ SA 260, paragraph 9.

¹⁴ SA 260, paragraph 12(c)(iii).

I.282 Auditing Pronouncements

- (a) The consideration of the aggregate effect of uncorrected misstatements;
- (b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and
- (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

Material Modifications to ISA 450, “Evaluation of Misstatements Identified during the Audit”

Deletions

Paragraph A19 of ISA 450 states that in the case of an audit of public sector entities, the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A19, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

SA 500*
Audit Evidence
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit (for example, SA 315¹), the audit evidence to be obtained in relation to a particular topic (for example, SA 570²), specific procedures to obtain audit evidence (for example, SA 520³), and the evaluation of whether sufficient appropriate audit evidence has been obtained (SA 200 and SA 330⁴).

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

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

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Accounting records – The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
 - (b) Appropriateness (of audit evidence) – The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.
 - (c) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's

* Published in April, 2009 issue of the Journal.

¹ SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

² SA 570, "Going Concern".

³ SA 520, "Analytical Procedures".

⁴ SA 330, "The Auditor's Responses to Assessed Risks".

I.284 Auditing Pronouncements

opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

- (d) Management's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
- (e) Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)

8. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, (Ref: Para. A34-A36)

- (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)
- (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)
- (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

- (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)
- (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

Inconsistency in, or Doubts over Reliability of, Audit Evidence

11. If:

- (a) audit evidence obtained from one source is inconsistent with that obtained from another; or
- (b) the auditor has doubts over the reliability of information to be used as audit evidence,

The auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

Application and Other Explanatory Material

Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A1. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is

primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit)⁵ or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

A2. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

A3. As explained in SA 200,⁶ reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

A4. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A5. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A6. SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.⁷ Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

A7. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

⁵ SA 315, paragraph 9.

⁶ SA 200, paragraph 5.

⁷ SA 330, paragraph 26.

A8. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

A9. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

A10. As required by, and explained further in, SA 315 and SA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (a) Risk assessment procedures; and
- (b) Further audit procedures, which comprise:
 - (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
 - (ii) Substantive procedures, including tests of details and substantive analytical procedures.

A11. The audit procedures described in paragraphs A14-A25 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in SA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance⁸.

A12. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

A13. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Inspection

A14. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

A15. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

⁸ SA 330, paragraph A35.

A16. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation

A17. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See SA 501 for further guidance on observation of the counting of inventory.⁹

External Confirmation

A18. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. See SA 505 for further guidance.¹⁰

Recalculation

A19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

A20. Repformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures

A21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See SA 520 for further guidance.

Inquiry

A22. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A23. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to

⁹ SA 501, "Audit Evidence—Specific Considerations for Selected Items".

¹⁰ SA 505, "External Confirmations".

modify or perform additional audit procedures.

A24. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

A25. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See SA 580 for further guidance.¹¹

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

A27. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A28. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

A29. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A30. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

¹¹ SA 580, "Written Representations".

Reliability

A31. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

A32. SA 520 provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.¹²

A33. SA 240 deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.¹³

Reliability of Information Produced by a Management's Expert (Ref: Para. 8)

A34. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this SA applies. For example, an individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organisation applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organisation is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this SA, but is not the use

¹² SA 520, paragraph 5 (a).

¹³ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 13.

I.290 Auditing Pronouncements

of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this SA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates to the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A38. Information regarding the competence, capabilities and objectivity of a management's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's expert.

A39. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A40. Other matters that may be relevant include:

- The relevance of the management's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialise in property and casualty insurance, but have limited expertise regarding pension calculations.
- The management's expert's competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

A41. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).

A42. Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.¹⁴

A45. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

¹⁴ SA 620, "Using the Work of an Auditor's Expert", paragraph 7.

I.292 Auditing Pronouncements

- The nature of internal and external data or information the auditor's expert uses.

A46. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Information Produced by the Entity and Used for the Auditor's Purposes (Ref: Para. 9(a)-(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorisation), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

A51. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

- (a) Selecting all items (100% examination);
- (b) Selecting specific items; and
- (c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

A53. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

A54. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- High value or key items. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

A55. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit Sampling

A56. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis

I.294 Auditing Pronouncements

of testing a sample drawn from it. Audit sampling is discussed in SA 530.¹⁵

Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.¹⁶

Material Modifications *vis a vis* ISA 500, "Audit Evidence"

SA 500, "Audit Evidence" does not contain any material modifications *vis-a-vis* ISA 500.

¹⁵ SA 530, "Audit Sampling".

¹⁶ SA 230, "Audit Documentation", paragraph 11.

SA 501*

**Audit Evidence—Specific Considerations for
Selected Items**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330¹, SA 500² and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:
- (a) Existence and condition of inventory;
 - (b) Completeness of litigation and claims involving the entity; and
 - (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Requirements

Inventory

4. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
- (a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1-A3)
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (Ref: Para. A4)
 - (ii) Observe the performance of management's count procedures; (Ref: Para. A5)
 - (iii) Inspect the inventory; and (Ref: Para. A6)
 - (iv) Perform test counts; and (Ref: Para. A7-A8)
 - (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

* Published in March, 2010 issue of the Journal.

¹ SA 330, "The Auditor's Responses to Assessed Risks".

² SA 500, "Audit Evidence".

I.296 Auditing Pronouncements

5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)
6. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.
7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705³. (Ref: Para. A12-A14)
8. When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:
 - (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)
 - (b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

Litigation and Claims

9. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17-A19)
 - (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
 - (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
 - (c) Reviewing legal expense accounts. (Ref: Para. A20)
10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. (Ref: Para. A21-A25)
11. If:
 - (a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
 - (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

³ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Written Representations

12. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Segment Information

13. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: (Ref: Para. A26)

- (a) Obtaining an understanding of the methods used by management in determining segment information, and: (Ref: Para. A27)
 - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
 - (ii) Where appropriate, testing the application of such methods; and
- (b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

Application and Other Explanatory Material

Inventory

Attendance at Physical Inventory Counting (Ref: Para. 4(a))

A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

A2. Attendance at physical inventory counting involves:

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this SA) include, for example:

- Nature of inventory.
- Stages of completion of work in progress.
- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of

I.298 Auditing Pronouncements

material misstatement at different locations, in deciding at which locations attendance is appropriate. SA 600, "Using the Work of Another Auditor" deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.

- Whether the assistance of an auditor's expert is needed. SA 620⁴ deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Evaluate Management's Instructions and Procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut off date.

Observe the Performance of Management's Count Procedures (Ref: Para. 4(a)(ii))

A5. Observing the performance of management's count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

Perform Test Counts (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Physical Inventory Counting Conducted Other than At the Date of the Financial Statements (Ref: Para. 5)

A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In

⁴ SA 620, "Using the Work of an Auditor's Expert".

either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date⁵.

A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Attendance at Physical Inventory Counting Is Impracticable (Ref: Para. 7)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200⁶, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A13. In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation⁷.

Inventory under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A15. SA 505⁸ establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

A16. Depending on the circumstances, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit

⁵ SA 330, paragraphs 22-23.

⁶ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph A48.

⁷ SA 705, paragraph 13.

⁸ SA 505, "External Confirmations".

I.300 Auditing Pronouncements

procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigation and Claims

Completeness of Litigations and Claims (Ref: Para. 9)

A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540⁹ establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Reviewing Legal Expense Accounts (Ref: Para. 9(c))

A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor's review of legal expense accounts.

Communication with the Entity's External Legal Counsel (Ref: Para. 10-11)

A21. Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

A22. In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity's external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

A23. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

- (a) A list of litigation and claims;
- (b) Where available, management's assessment of the outcome of each of the identified litigation and

⁹ SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

claims and its estimate of the financial implications, including costs involved; and

- (c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- The matter is complex.
- There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

A25. In accordance with Revised SA 700¹⁰, the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Segment Information (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

Understanding of the Methods Used by Management (Ref: Para. 13(a))

A27. Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Modifications vis-a-vis ISA 501, "Audit Evidence—Specific Considerations for Selected Items"

SA 501, "Audit Evidence—Specific Considerations for Selected Items" does not contain any modifications vis-à-vis ISA 501.

¹⁰ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

SA 505*
External Confirmations
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330¹ and SA 500². It does not address inquiries regarding litigation and claims. SA 501³ deals with obtaining sufficient appropriate audit evidence from such inquiries.

External Confirmation Procedures to Obtain Audit Evidence

2. SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained⁴. That SA also includes the following generalisations applicable to audit evidence⁵:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

3. Other SAs recognise the importance of external confirmations as audit evidence, for example:
- SA 330 discusses the auditor's responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level⁶. In addition, SA 330 requires that,

* Published in March, 2010 issue of the Journal.

¹ SA 330, "The Auditor's Responses to Assessed Risks".

² SA 500, "Audit Evidence".

³ SA 501, "Audit Evidence—Specific Considerations for Selected Items".

⁴ SA 500, paragraph A5.

⁵ SA 500, paragraph A31.

⁶ SA 330, paragraphs 5-6.

irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether external confirmation procedures are to be performed as substantive audit procedures⁷.

- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk⁸. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. SA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error⁹.
- SA 240 indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level¹⁰.
- SA 500 indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from the representations made by the management¹¹.

Effective Date

4. This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.

Objective

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

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
 - a) External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
 - b) Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
 - c) Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
 - d) Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
 - e) Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

⁷ SA 330, Paragraph 18 and 19.

⁸ SA 330, paragraph 7(b).

⁹ SA 330, paragraph A53.

¹⁰ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph A37.

¹¹ SA 500, paragraph A8.

I.304 Auditing Pronouncements

Requirements

External Confirmation Procedures

7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
- (b) Selecting the appropriate confirming party; (Ref: Para. A2)
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and (Ref: Para. A3-A6)
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7)

Management's Refusal to Allow the Auditor to Send a Confirmation Request

8. If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness; (Ref: Para. A8)
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and (Ref: Para. A9)
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: Para. A10)

9. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260¹². The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705¹³.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests

10. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Para. A11-A16)

11. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para. A17)

Non-Responses

12. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18-A19)

¹² SA 260, "Communication with Those Charged with Governance", paragraph 12.

¹³ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with SA 705. (Ref: Para A20)

Exceptions

14. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements. (Ref: Para. A21-A22)

Negative Confirmations

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Evaluating the Evidence Obtained

16. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary. (Ref: Para A24-A25)

Application and Other Explanatory Material

External Confirmation Procedures

Determining the Information to be Confirmed or Requested (Ref: Para. 7(a))

A1. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

Selecting the Appropriate Confirming Party (Ref: Para. 7(b))

A2. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

Designing Confirmation Requests (Ref: Para. 7(c))

A3. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

I.306 Auditing Pronouncements

A4. Factors to consider when designing confirmation requests include:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The method of communication (for example, in paper form, or by electronic or other medium).
- Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A5. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

A6. Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

Follow-Up on Confirmation Requests (Ref: Para. 7(d))

A7. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management's Refusal to Allow the Auditor to Send a Confirmation Request

Reasonableness of Management's Refusal (Ref: Para. 8(a))

A8. A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

Implications for the Assessment of Risks of Material Misstatement (Ref: Para. 8(b))

A9. The auditor may conclude from the evaluation in paragraph 8(b) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit

procedures in accordance with SA 315¹⁴. For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240¹⁵.

Alternative Audit Procedures (Ref: Para. 8(c))

A10. The alternative audit procedures performed may be similar to those appropriate for a non-response as set out in paragraphs A18-A19 of this SA. Such procedures also would take account of the results of the auditor's evaluation in paragraph 8(b) of this SA.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests (Ref: Para. 10)

A11. SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability¹⁶. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

A12. Responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify website authenticity.

A13. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:

- (a) The response may not be from the proper source;
- (b) A respondent may not be authorised to respond; and
- (c) The integrity of the transmission may have been compromised.

A14. The auditor is required by SA 500 to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence¹⁷. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response. When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than to the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.

A15. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances, request the confirming

¹⁴ SA 315, paragraph 31.

¹⁵ SA 240, paragraph 24.

¹⁶ SA 500, paragraph A31.

¹⁷ SA 500, paragraph 11.

I.308 Auditing Pronouncements

party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.

A16. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

Unreliable Responses (Ref: Para. 11)

A17. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with SA 315¹⁸. For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SA 240¹⁹.

Non-Responses (Ref: Para. 12)

A18. Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A19. The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315²⁰. For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with SA 240²¹.

When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 13)

A20. In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include where:

- The information available to corroborate management's assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

Exceptions (Ref: Para. 14)

A21. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by SA 240 to evaluate whether such misstatement is indicative of fraud²². Exceptions may provide a guide to the

¹⁸ SA 315, paragraph 31.

¹⁹ SA 240, paragraph 24.

²⁰ SA 315, paragraph 31.

²¹ SA 240, paragraph 24.

²² SA 240, paragraph 35.

quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

A22. Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

Negative Confirmations (Ref: Para. 15)

A23. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

Evaluating the Evidence Obtained (Ref: Para. 16)

A24. When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- (b) A response deemed unreliable;
- (c) A non-response; or
- (d) A response indicating an exception.

A25. The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330²³.

Modifications *vis-a-vis* ISA 505, "External Confirmations"

SA 505, "External Confirmations" does not contain any modifications *vis-à-vis* ISA 505.

²³ SA 330, paragraphs 27-28.

SA 510*

Initial Audit Engagements—Opening Balances
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in SA 710¹ also apply. SA 300² includes additional requirements and guidance regarding activities prior to starting an initial audit.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Definitions

4. For the purposes of the SAs, the following terms have the meanings attributed below:

- (a) Initial audit engagement – An engagement in which either:
 - (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor.
- (b) Opening balances – Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
- (c) Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

* Published in March, 2009 issue of the Journal.

¹ SA 710, "Comparative Information- Corresponding Figures and Comparatives Financial Statements".

² SA 300, "Planning an Audit of Financial Statements".

Requirements

Audit Procedures

Opening Balances

5. The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.
6. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss³;
 - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
 - (c) Performing one or more of the following: (Ref: Para. A1–A4)
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.
7. If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with SA 450⁴.

Consistency of Accounting Policies

8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Relevant Information in the Predecessor Auditor's Report

9. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with SA 315.⁵

³ Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

⁴ SA 450, "Evaluation of Misstatements Identified During the Audit", paragraphs 8 and 12.

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

I.312 Auditing Pronouncements

Audit Conclusions and Reporting

Opening Balances

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.⁶ (Ref: Para. A5)

11. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

Consistency of Accounting Policies

12. If the auditor concludes that:

- (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
- (b) a change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.

Modification to the Opinion in the Predecessor Auditor's Report

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with SA 705 and SA 710. (Ref: Para. A6)

Application and Other Explanatory Material

Audit Procedures (Ref: Para. 6)

Opening Balances (Ref: Para. 6(c))

A1. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

A2. If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of

⁶ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

misstatements in opening balances is indicated.

A3. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

A4. For non-current assets and liabilities, such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening Balances (Ref: Para. 10)

A5. SA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

- (a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or
- (b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations*, and cash flows, where relevant, and unmodified regarding State of Affairs*.

The Appendix includes illustrative auditor's reports.

Modification to the Opinion in the Predecessor Auditor's Report (Ref: Para. 13)

A6. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

Material Modifications vis a vis ISA 510, "Initial Audit Engagements - Opening Balances"

Deletions

1. Paragraph 6 (a) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by determining whether the prior period's closing balances have been correctly brought forward

* Profit & Loss Account.

* Balance Sheet.

I.314 Auditing Pronouncements

to the current period or, when appropriate, have been restated. Since in India Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss.

2. Paragraph 6 (c) (i) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by reviewing the predecessor auditor's working papers, where the prior year financial statements were audited. Since in India Clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of Code of Ethics, the requirement of reviewing the predecessor auditor's working papers has been replaced with the requirement of perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements. Corresponding change has also been made in the paragraph A4 of ISA 510 and Paragraphs A1 and A5 have been deleted.

3. Paragraph A2 of ISA 510 dealt with the outsourcing of an audit of a public sector entity by the statutorily appointed auditor to a private sector audit firm. Since in the Indian context such situation does not exist, the paragraph A2 of the application part has been deleted completely.

Appendix

(Ref: Para. A5)

Illustrations of Auditors' Reports with Modified Opinions*

Illustration 1:

Circumstances described in paragraph A5 (a) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's results of operations and cash flows.⁷
- The State of Affairs at year end gives a true and fair view.
- In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs.

* The Reporting Standards may give rise to conforming amendments to the illustrations of auditors' reports.

⁷ If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim an opinion on the results of operations and cash flows.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁸

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of financial statements that give a true and fair view in accordance with applicable Accounting Standards.⁹ This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation¹⁰ of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.¹¹ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

⁸ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

⁹ Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

¹⁰ Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control".

¹¹ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 13, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

Basis for Qualified Opinion

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1, and of its Results of Operations and its cash flows for the year then ended in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities].

For ABC and Co.
Chartered Accountants
Firm's Registration Number
Signature
(Name of the Member Signing the Audit Report)
(Designation¹²)
Membership Number

Place of Signature

Date

Illustration 2:

Circumstances described in paragraph A5 (b) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's results of operations and cash flows.¹³
- The State of Affairs at year end gives a true and fair view.
- An opinion that is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs is considered appropriate in the circumstances.

¹² Partner or Proprietor, as the case may be.

¹³ If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim the opinion on the results of operations and cash flows.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements¹⁴

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation¹⁵ of financial statements that give a true and fair view in accordance with applicable Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation¹⁶ of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.¹⁷ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the State of Affairs and our qualified audit opinion on the results of operations and cash flows.

¹⁴ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁵ Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

¹⁶ Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control".

¹⁷ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 19, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

Basis for Qualified Opinion on the results of operations and Cash Flows

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion on the results of operations and Cash Flows

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Statement of Profit and Loss and Cash Flow Statement give a true and fair view of the results of operations and cash flows of ABC Company for the year ended March 31, 20X1 in accordance with applicable Accounting Standards.

Opinion on the State of Affairs

In our opinion, the balance sheet gives a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1 in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For ABC and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁸)
Membership Number

Place of Signature

Date

¹⁸ Partner or Proprietor, as the case may be.

SA 520*
Analytical Procedures
***(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. The use of analytical procedures as risk assessment procedures is dealt with in SA 315¹. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures².

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

3. The objectives of the auditor are:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Definition

4. For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor's choice of procedures, methods and level of application is a matter of professional judgement. (Ref: Para. A1-A3)

Requirements

Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330³, the auditor shall: (Ref: Para. A4-A5)

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking

*Published in March, 2010 issue of the Journal.

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 6 (b) and A7-A10.

² SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 6 and 18.

³ SA 330, paragraph 18.

I.320 Auditing Pronouncements

account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6-A11)

- (b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12-A14)
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

Analytical Procedures that Assist When Forming an Overall Conclusion

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17-A19)

Investigating Results of Analytical Procedures

7. If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A20-A21)

Application and Other Explanatory Material

Nature of Analytical Procedures (Ref: Para. 4)

A1. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

A2. Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

A3. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Substantive Analytical Procedures (Ref: Para. 5)

A4. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

A5. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Suitability of Particular Analytical Procedures for Given Assertions (Ref: Para. 5(a))

A6. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

A7. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

A8. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

A9. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

A10. Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Considerations Specific to Public Sector Entities

A11. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue

I.322 Auditing Pronouncements

and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalised, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

The Reliability of the Data (Ref: Para. 5(b))

A12. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity⁴;
- (b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

A13. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures⁵.

A14. The matters discussed in paragraphs A12(a)-A12(d) are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity's period end financial statements, or at an interim date and plans to perform substantive analytical procedures for the remaining period. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date⁶.

Evaluation of Whether the Expectation Is Sufficiently Precise (Ref: Para. 5(c))

A15. Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one

⁴ SA 500, "Audit Evidence", paragraph A31.

⁵ SA 500, paragraph 10.

⁶ SA 330, paragraphs 22-23.

period to another than in comparing discretionary expenses, such as research or advertising.

- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A12 - A13 above.

Amount of Difference of Recorded Amounts from Expected Values that Is Acceptable (Ref: Para. 5(d))

A16. The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality⁷ and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk⁸. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence⁹.

Analytical Procedures that Assist When Forming an Overall Conclusion (Ref: Para. 6)

A17. The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

A18. The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly¹⁰.

A19. The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures (Ref: Para. 7)

A20. Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

A21. The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Modifications *vis-a-vis* ISA 520, "Analytical Procedures"

SA 520, "Analytical Procedures" does not contain any modifications *vis-à-vis* ISA 520.

⁷ SA 320, "Materiality in Planning and Performing an Audit", paragraph A13.

⁸ SA 330, paragraph 7(b).

⁹ SA 330, paragraph A19.

¹⁰ SA 315, paragraph 31.

Analytical Procedures

Trends

Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

Reasonableness

Tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. Examples of accounts that may be reasonably tested are:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

Ratios

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

Sources of information

- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Bank and cash records
- VAT returns
- Board minutes
- Discussion or correspondence with the client at the year-end

SA 530*
Audit Sampling
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.
2. This SA complements SA 500¹, which deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

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

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Audit sampling (sampling) – The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
 - (b) Population – The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
 - (c) Sampling risk – The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
 - (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

* Published in February, 2009 issue of the Journal.

¹ SA 500, "Audit Evidence".

I.326 Auditing Pronouncements

- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- (d) Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. *(Ref: Para A1)*
- (e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- (f) Sampling unit – The individual items constituting a population. *(Ref: Para A2)*
- (g) Statistical sampling – An approach to sampling that has the following characteristics:
 - (i) Random selection of the sample items; and
 - (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.
- (h) Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- (i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. *(Ref: Para. A3)*
- (j) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Requirements

Sample Design, Size and Selection of Items for Testing

- 6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. *(Ref: Para. A4-A9)*
- 7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. *(Ref: Para. A10-A11)*
- 8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. *(Ref: Para. A12-A13)*

Performing Audit Procedures

- 9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
- 10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. *(Ref: Para. A14)*
- 11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. *(Ref: Para. A15-A16)*

Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)

13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

Evaluating Results of Audit Sampling

15. The auditor shall evaluate:

- (a) The results of the sample; and (Ref: Para. A21-A22)
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Application and Other Explanatory Material

Definitions

Non-Sampling Risk (Ref: Para. 5(d))

A1. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Sampling Unit (Ref: Para. 5(f))

A2. The sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units.

Tolerable Misstatement (Ref: Para. 5(i))

A3. When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in SA 320², to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Sample Design, Size and Selection of Items for Testing

Sample Design (Ref: Para. 6)

A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

² SA 320, "Materiality in Planning and Performing an Audit", paragraph 9.

A5. When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 8 of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. Appendix 1 provides further discussion on stratification and value-weighted selection.

A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample Size (Ref: Para. 7)

A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen.

Selection of Items for Testing (Ref: Para. 8)

A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative

sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

Performing Audit Procedures (Ref: Para. 10-11)

A14. An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

A15. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

Nature and Cause of Deviations and Misstatements (Ref: Para. 12)

A17. In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

Projecting Misstatements (Ref: Para. 14)

A18. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

A19. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

A20. For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. SA 330³ provides guidance when deviations from controls upon which the auditor intends to rely are detected.

Evaluating Results of Audit Sampling (Ref: Para. 15)

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the

³ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

I.330 Auditing Pronouncements

population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Material Modifications *vis a vis* ISA 530, "Audit Sampling"

SA 530, "Audit Sampling" does not contain any material modifications *vis à vis* ISA 530.

Appendix 1 (Ref: Para. A8)

Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. This Appendix provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).
4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Value-Weighted Selection

5. When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection (described in Appendix 4) and is most efficient when selecting items using random selection.

Appendix 2

(Ref: Para. A11)

Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures

I.332 Auditing Pronouncements

		undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
5. An increase in the number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 3

(Ref: Para. A11)

Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.
7. The number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).

Appendix 4

(Ref: Para. A13)

Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

- (a) Random selection (applied through random number generators, for example, random number tables).
- (b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- (c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- (e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

SA 540*

Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
(Effective for audits of financial statements for periods beginning on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315¹ and SA 330² and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: Para. A1-A11)

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.³

4. A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is

* Published in February, 2009 issue of the Journal.

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

² SA 330, "The Auditor's Responses to Assessed Risks".

³ Different definitions of fair value may exist among financial reporting frameworks.

invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

- (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- (b) related disclosures in the financial statements are adequate.

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) **Accounting estimate** – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.
- (b) **Auditor’s point estimate or auditor’s range** – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management’s point estimate.
- (c) **Estimation uncertainty** – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
- (d) **Management bias** – A lack of neutrality by management in the preparation and presentation of information.
- (e) **Management’s point estimate** – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
- (f) **Outcome of an accounting estimate** – The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Requirements

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity’s internal control, as required by SA 315,⁴ the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)

- (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13-A15)
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that

⁴ SA 315, paragraphs 5-6 and 11-12.

may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16-A21)

- (c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: (Ref: Para. A22-A23)
- (i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24-A26)
 - (ii) Relevant controls; (Ref: Para. A27-A28)
 - (iii) Whether management has used an expert; (Ref: Para. A29-A30)
 - (iv) The assumptions underlying the accounting estimates; (Ref: Para. A31-A36)
 - (v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37)
 - (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38)

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. (Ref: Para. A39-A44)

Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by SA 315,⁵ the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: Para. A45-A46)

11. The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: Para. A47-A51)

Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine: (Ref: Para. A52)

- (a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A53-A56)
- (b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. A57-A58)

13. In responding to the assessed risks of material misstatement, as required by SA 330,⁶ the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59- A61)

- (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62-A67)
- (b) Test how management made the accounting estimate and the data on which it is based. In doing so,

⁵ SA 315, paragraph 25.

⁶ SA 330, paragraph 5.

I.338 Auditing Pronouncements

the auditor shall evaluate whether: (Ref: Para. A68-A70)

- (i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71-A76)
 - (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77-A83)
- (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84- A86)
- (d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87-A91)
- (i) When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)
 - (ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93-A95)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialised skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96-A101)

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330,⁷ the auditor shall evaluate the following: (Ref: Para. A102)

- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103-A106)
- (b) Whether the significant assumptions used by management are reasonable. (Ref: Para A107-A109)
- (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

- (a) management's decision to recognise, or to not recognise, the accounting estimates in the financial

⁷ SA 330, paragraph 18.

statements; and (Ref: Para. A113-A114)

- (b) the selected measurement basis for the accounting estimates. (Ref: Para. A115)

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable. (Ref: Para. A126-A127)

Documentation

23. The audit documentation shall include:

- (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
- (b) Indicators of possible management bias, if any. (Ref: Para. A128)

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this SA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

I.340 Auditing Pronouncements

- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as “observable” in the context of a fair value accounting estimate.
 - Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
 - Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.
- A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:
- Accounting estimates relating to the outcome of litigation.
 - Fair value accounting estimates for derivative financial instruments not publicly traded.
 - Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.
- A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.
- A5. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.
- A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:
- Allowance for doubtful accounts.
 - Inventory obsolescence.
 - Warranty obligations.
 - Depreciation method or asset useful life.
 - Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
 - Outcome of long term contracts.
 - Financial Obligations / Costs arising from litigation settlements and judgments.
- A7. Additional examples of situations where fair value accounting estimates may be required include:
- Complex financial instruments, which are not traded in an active and open market.
 - Share-based payments.

- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A11. Certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Often specialised assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this SA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

I.342 Auditing Pronouncements

- Prescribes certain conditions for the recognition,⁸ or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability.
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.⁹ Others may require, for example, use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting estimate to be recognised in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: Para. 8(b))

A16. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting

⁸ Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognise such items, including accounting estimates.

⁹ Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

estimates as necessary. The completeness of accounting estimates is often an important consideration for the auditor particularly accounting estimates relating to liabilities.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.¹⁰

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly.

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).

¹⁰ SA 315, paragraph 16.

I.344 Auditing Pronouncements

- Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management selects a particular method considering the nature of the asset or liability being estimated.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular industry or environment.

Relevant Controls (Ref: Para. 8(c)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model.
- The maintenance and periodic validation of the integrity of the model.

Management's Use of Experts (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialised nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.
- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

Considerations Specific to Smaller Entities

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what

I.346 Auditing Pronouncements

knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).
- (b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent). In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by SA 240.¹¹ That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SA may be carried out in conjunction with the review required by SA 240.

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognised in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalised, or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

¹¹ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 32(b)(ii).

Identifying and Assessing the Risks of Material Misstatement

Estimation Uncertainty (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

High Estimation Uncertainty and Significant Risks (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair

value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.¹²

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. SA 570¹³ establishes requirements and provides guidance in such circumstances.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 12)

A52. SA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.¹⁴ Paragraphs A53-A115 focus on specific responses at the assertion level only.

Application of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Consistency in Methods and Basis for Changes (Ref: Para. 12(b))

A57. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been

¹² SA 315, paragraph 29.

¹³ SA 570, "Going Concern".

¹⁴ SA 330, paragraphs 5-6.

I.350 Auditing Pronouncements

a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Responses to the Assessed Risks of Material Misstatements (Ref: Para. 13)

A59. The auditor's decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non-routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realisable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with SA 560¹⁵. The auditor is required to perform audit

¹⁵ Standard on Auditing (SA) 560, "Subsequent Events".

procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified¹⁶ and appropriately reflected in the financial statements.¹⁷ Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under SA 560 is particularly relevant.

Considerations Specific to Smaller Entities

A67. When there is a longer period between the balance sheet date and the date of the auditor's report, the auditor's review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner-managed entities, especially when management does not have formalised control procedures over accounting estimates.

Testing how Management made the Accounting Estimate (Ref: Para. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Re-calculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.
- Considering management's review and approval processes.

Considerations Specific to Smaller Entities

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the Method of Measurement (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a

¹⁶ SA 560, paragraph 6.

¹⁷ SA 560, paragraph 7.

I.352 Auditing Pronouncements

matter of professional judgment.

A72. For this purpose, matters that the auditor may consider include, for example, whether:

- Management's rationale for the method selected is reasonable.
- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
- The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

Evaluating the use of Models

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
 - The model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters.
 - The consistency and completeness of the model's inputs with market practices.
 - The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented; including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

Assumptions Used by Management (Ref: Para. 13(b)(ii))

A77. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context of the audit of the entity's financial statements, and not for the purpose of providing

an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorisations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market specific inputs into the development of assumptions.

I.354 Auditing Pronouncements

- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.
- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102- A115.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A85. Testing the operating effectiveness of the controls is required when:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or
- (b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.¹⁸

Considerations Specific to Smaller Entities

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the

¹⁸ SA 330, paragraph 8.

formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

Developing a Point Estimate or Range (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate or a range.

A88. Even when the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

- (a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and
- (b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering whether Specialised Skills or Knowledge are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement¹⁹. This may include, as necessary, the involvement of those with specialised skills or knowledge. In addition, SA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts, collectively have the appropriate capabilities, competence and time to perform the audit engagement.²⁰ During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialised skills or knowledge to be applied in relation to one or more aspects of

¹⁹ SA 300, "Planning an Audit of Financial Statements", paragraph 7(e).

²⁰ SA 220, "Quality Control for and Audit of Financial Statements", paragraph 14.

the accounting estimates.

A97. Matters that may affect the auditor's consideration of whether specialised skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).
- A high degree of estimation uncertainty.
- Complex calculations or specialised models are involved, for example, when estimating fair values when there is no observable market.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialised skills or knowledge will be required. For example, it is unlikely that specialised skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialised skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. SA 620²¹ establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialised skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organisation outside of the auditor's firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in SA 220.

A101. Depending on the auditor's understanding and experience of working with the auditor's expert or those other individuals with specialised skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of:

- (a) How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and
- (b) The adequacy of related disclosures.

Estimation Uncertainty

Management's Consideration of Estimation Uncertainty (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies

²¹ SA 620, "Using the Work of an Auditor's Expert".

I.358 Auditing Pronouncements

with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as “pessimistic” and “optimistic” scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor’s attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management’s consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

Considerations Specific to Smaller Entities

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor’s review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation and presentation of the financial statements.

Significant Assumptions (Ref: Para. 15(b))

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management’s knowledge may be obtained from management’s continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor’s considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

Management Intent and Ability (Ref: Para. 15(c))

A110. The auditor’s considerations in relation to assumptions made by management and management’s intent and ability are described in paragraphs A13 and A80.

Development of a Range (Ref: Para. 16)

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor’s judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 17(a))

A113. Where management has recognised an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognised, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. SA 706²² establishes requirements and provides guidance concerning such paragraphs.

Measurement Basis for the Accounting Estimates (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements (Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).

²² SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

I.360 Auditing Pronouncements

A118.SA 450²³ provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119.Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements.

Disclosures Related to Accounting Estimates

Disclosures in accordance with the Applicable Financial Reporting Framework (Ref: Para. 19)

A120.The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognised or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121.In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates".
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the

²³ SA 450, "Evaluation of Misstatements Identified during the Audit".

entity's financial position and performance.

- Qualitative disclosures such as the exposures to risk and how they arise, the entity's objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

Disclosures of Estimation Uncertainty for Accounting Estimates that give Rise to Significant Risks
(Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95 & A94).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. SA 705²⁴ provides guidance on the implications for the auditor's report when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

Indicators of Possible Management Bias (Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in Revised SA 700²⁵

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Written Representations (Ref: Para. 22)

A126. SA 580²⁶ discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models,

²⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

²⁵ Revised SA 700, "Forming An Opinion and Reporting on Financial Statements".

²⁶ Standard on Auditing (SA) 580, "Written Representations".

I.362 Auditing Pronouncements

used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

Material Modifications vis a vis ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

Deletions

1. Paragraph A11 of the Application Section of ISA 540 deals with the application of the requirements of ISA 540 to the audits of public sector entities regarding significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even non-public sector entities, may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement. Accordingly, the spirit of erstwhile A11, highlighting the fact that in case of certain entities, there may be a requirement of estimation at fair value in case of specialised assets, has been retained.

Appendix

(Ref: Para. A1)

Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Accounting Standard (AS) 30²⁷ defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as “entity-specific value,” “value in use,” or similar terms, but may still fall within the concept of fair value in this SA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management’s intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

- Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
- Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or
- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

²⁷ AS 30, “Financial Instruments: Recognition and Measurement”.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly “observable inputs” based on quoted prices and active markets and those “unobservable inputs” that involve an entity’s own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property’s condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management’s plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

Prevalence of Fair Value Measurements

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically “marked-to-market”.
- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.
- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting

frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.

- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognised in the financial statements.

SA 550*
RELATED PARTIES
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315¹, SA 330² and SA 240³ are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

Nature of Related Party Relationships and Transactions

2. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Responsibilities of the Auditor

3. Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

4. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as

* Published in March, 2009 issue of the Journal.

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

² SA 330, "The Auditor's Responses to Assessed Risks".

³ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

they are affected by those relationships and transactions: (Ref: Para. A1)

- (a) Achieve a true and fair presentation (for fair presentation frameworks); or (Ref: Para. A2)
- (b) Are not misleading (for compliance frameworks). (Ref: Para. A3)

5. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by SA 240⁴ because fraud may be more easily committed through related parties.

6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs⁵. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

7. Planning and performing the audit with professional skepticism as required by SA 200⁶ is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

9. The objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:
 - (i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
 - (ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve a true and fair presentation (for fair presentation frameworks); or
 - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements

⁴ SA 240, paragraph 24.

⁵ SA 200, paragraph A52.

⁶ SA 200, paragraph 15.

in accordance with the framework.

Definitions

10. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Arm's length transaction—A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.
- (b) Related party – A party that is either: (*Ref: Para. A4-A7*)
 - (i) A related party as defined in the applicable financial reporting framework⁷; or
 - (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Requirements

Risk Assessment Procedures and Related Activities

11. As part of the risk assessment procedures and related activities that SA 315 and SA 240 require the auditor to perform during the audit,⁸ the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (*Ref: Para. A8*)

Understanding the Entity's Related Party Relationships and Transactions

12. The engagement team discussion that SA 315 and SA 240 require⁹ shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. (*Ref: Para. A9-A10*)

13. The auditor shall inquire of management regarding:

- (a) The identity of the entity's related parties, including changes from the prior period; (*Ref: Para. A11-A14*)
- (b) The nature of the relationships between the entity and these related parties; and

⁷ In Indian context, definitions of "Related Party" and "Related Party Transactions" as given in Accounting Standard (AS) 18, "Related Party Disclosures", issued by the Institute of Chartered Accountants of India, will be applicable for the purposes of this SA, and the said definitions also meet the tests laid down in paragraph 10(b)(ii) of this SA.

⁸ SA 315, paragraph 5; and SA 240, paragraph 16.

⁹ SA 315, paragraph 10; and SA 240, paragraph 15.

- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

14. The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to: (Ref: Para. A15-A20)

- (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- (b) Authorise and approve significant transactions and arrangements with related parties; and (Ref: Para. A21)
- (c) Authorise and approve significant transactions and arrangements outside the normal course of business.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. (Ref: Para. A22-A23)

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank, legal and third party confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

16. If the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about: (Ref: Para. A24-A25)

- (a) The nature of these transactions; and (Ref: Para. A26)
- (b) Whether related parties could be involved. (Ref: Para. A27)

Sharing Related Party Information with the Engagement Team

17. The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team. (Ref: Para. A28)

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

18. In meeting the SA 315 requirement to identify and assess the risks of material misstatement,¹⁰ the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

19. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing

¹⁰ SA 315, paragraph 25.

I.370 Auditing Pronouncements

the risks of material misstatement due to fraud in accordance with SA 240. (Ref: Para. A6 and A29-A30)

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

20. As part of the SA 330 requirement that the auditor respond to assessed risks,¹¹ the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24. (Ref: Para. A31-A34)

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

21. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

22. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- (a) Promptly communicate the relevant information to the other members of the engagement team; (Ref: Para. A35)
- (b) Where the applicable financial reporting framework establishes related party requirements:
 - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
 - (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- (c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions; (Ref: Para. A36)
- (d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
- (e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. (Ref: Para. A37)

Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

23. For identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- (a) Inspect the underlying contracts or agreements, if any, and evaluate whether:
 - (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;¹² (Ref: Para. A38-A39)
 - (ii) The terms of the transactions are consistent with management's explanations; and
 - (iii) The transactions have been appropriately accounted for and disclosed in accordance with the

¹¹ SA 330, paragraphs 5-6.

¹² SA 240, paragraph 32(c).

applicable financial reporting framework; and

- (b) Obtain audit evidence that the transactions have been appropriately authorised and approved. (Ref: Para. A40-A41)

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction

24. When management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. A42-A45)

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

25. In forming an opinion on the financial statements in accordance with SA 700,¹³ the auditor shall evaluate: (Ref: Para. A46)

- (a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and (Ref: Para. A47)
- (b) Whether the effects of the related party relationships and transactions:
- (i) Prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or
 - (ii) Cause the financial statements to be misleading (for compliance frameworks).

Written Representations

26. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48-A49)

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

Communication with Those Charged with Governance

27. Unless all of those charged with governance are involved in managing the entity¹⁴, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties. (Ref: Para. A50)

Documentation

28. In meeting the documentation requirements of SA 230¹⁵ and other SAs, the auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

¹³ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; paragraphs 10-15.

¹⁴ SA 260, paragraph 12 (c).

¹⁵ SA 230, "Audit Documentation".

Application and Other Explanatory Material

Responsibilities of the Auditor

Financial Reporting Frameworks That Establish Minimal Related Party Requirements (Ref: Para. 4)

A1. An applicable financial reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but that definition has a substantially narrower scope than the definition set out in paragraph 10(b)(ii) of this SA, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions.

Fair Presentation Frameworks (Ref: Para. 4(a))

A2. In the context of a fair presentation framework,¹⁶ related party relationships and transactions may cause the financial statements to fail to achieve true and fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, true and fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend.

Compliance Frameworks (Ref: Para. 4(b))

A3. In the context of a compliance framework, whether related party relationships and transactions cause the financial statements to be misleading as discussed in SA 700 depends upon the particular circumstances of the engagement. For example, even if non-disclosure of related party transactions in the financial statements is in compliance with the framework and applicable law or regulation, the financial statements could be misleading if the entity derives a very substantial portion of its revenue from transactions with related parties, and that fact is not disclosed. However, it will be extremely rare for the auditor to consider financial statements that are prepared and presented in accordance with a compliance framework to be misleading if in accordance with SA 210¹⁷ the auditor determined that the framework is acceptable¹⁸.

Definition of a Related Party (Ref: Para. 10(b))

A4. Many financial reporting frameworks discuss the concepts of control and significant influence. Although they may discuss these concepts using different terms, they generally explain that:

- (a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and
- (b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

A5. The existence of the following relationships may indicate the presence of control or significant influence:

- (a) Direct or indirect equity holdings or other financial interests in the entity.
- (b) The entity's holdings of direct or indirect equity or other financial interests in other entities.
- (c) Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).

¹⁶ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 13 (a), defines the meaning of fair presentation and compliance frameworks.

¹⁷ SA 210, "Agreeing the Terms of Audit Engagements," paragraph 4(a).

¹⁸ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph A12.

- (d) Being a close family member of any person referred to in subparagraph (c).
- (e) Having a significant business relationship with any person referred to in subparagraph (c).

Related Parties with Dominant Influence

A6. Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs A29-A30.

Special-Purpose Entities as Related Parties

A7. In some circumstances, a special-purpose entity¹⁹ may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special- purpose entity's equity.

Risk Assessment Procedures and Related Activities

Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 11)

A8. In case of certain entities, auditor's responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. Consequently, in such cases the auditor's responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing such entities that lay down specific requirements in the conduct of business with related parties. Further, in such cases the auditor may need to have regard to any specific financial reporting requirements for related party relationships and transactions that may differ from other entities.

Understanding the Entity's Related Party Relationships and Transactions

Discussion among the Engagement Team (Ref: Para. 12)

- A9. Matters that may be addressed in the discussion among the engagement team include:
- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
 - An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
 - The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).
 - The records or documents that may indicate the existence of related party relationships or transactions.
 - The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

¹⁹ SA 315, paragraphs A26-A27, provides guidance regarding the nature of a special-purpose entity.

I.374 Auditing Pronouncements

A10. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

- How special-purpose entities controlled by management might be used to facilitate earnings management.
- How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

The Identity of the Entity's Related Parties (Ref: Para. 13(a))

A11. Where the applicable financial reporting framework establishes related party requirements, information regarding the identity of the entity's related parties is likely to be readily available to management because the entity's information systems will need to record, process and summarise related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of the framework. Management is therefore likely to have a comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the auditor's record of related parties noted in previous audits.

A12. However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this SA.

In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with SA 315 to obtain information regarding:

- The entity's ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

A13. In the context of a group audit, SA 600 requires the group engagement team to provide each component auditor with a list of related parties prepared by group management and any other related parties of which the group engagement team is aware²⁰. Where the entity is a component within a group, this information provides a useful basis for the auditor's inquiries of management regarding the identity of the entity's related parties.

A14. The auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

The Entity's Controls over Related Party Relationships and Transactions (Ref: Para. 14)

A15. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may

²⁰ Currently, SA 600, 'Using the Work of Another Auditor' is in force. The standard is being revised in light of the corresponding international standard.

include, to the extent that they do not form part of management:

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel;
- Internal auditors;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A16. The audit is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and for such internal control as management and, where appropriate, those charged with governance, determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.²¹ Accordingly, where the framework establishes related party requirements, management, with oversight from those charged with governance, is responsible for the design, implementation and maintenance of adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance are responsible for monitoring how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in order to fulfill their oversight responsibilities, obtain information from management to enable them to understand the nature and business rationale of the entity's related party relationships and transactions.

A17. In meeting the SA 315 requirement to obtain an understanding of the control environment,²² the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarising, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by internal auditors, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.

²¹ SA 200, paragraph A2.

²² SA 315, paragraph 14.

I.376 Auditing Pronouncements

- The existence of whistle-blowing policies and procedures, where applicable.

A18. Controls over related party relationships and transactions within some entities may be deficient or non-existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, for example, the existence of transactions involving family members of management.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case, the auditor would, in accordance with SA 705²³, consider the implications for the audit, including the auditor's report.

A19. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.²⁴ The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

Considerations specific to smaller entities

A20. Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists. Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of

²³SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

²⁴ SA 240, paragraphs 31 and A4.

available relevant documentation.

Authorisation and approval of significant transactions and arrangements (Ref: Para. 14(b))

A21. Authorisation involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not. Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorisation was granted. Examples of controls the entity may have established to authorise and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include:

- Monitoring controls to identify such transactions and arrangements for authorisation and approval.
- Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

Records or Documents That the Auditor May Inspect (Ref: Para. 15)

A22. During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (e.g, prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions

A23. An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.
- The provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.

I.378 Auditing Pronouncements

- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business (Ref: Para. 16)

A24. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

A25. Examples of transactions outside the entity's normal course of business may include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business (Ref: Para. 16(a))

A26. Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

Inquiring into whether related parties could be involved (Ref: Para. 16(b))

A27. A related party could be involved in a significant transaction outside the entity's normal course of business not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

Sharing Related Party Information with the Engagement Team (Ref: Para. 17)

A28. Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are financially involved.

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

Fraud Risk Factors Associated with a Related Party with Dominant Influence (Ref: Para. 19)

A29. Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor.²⁵ Indicators of dominant influence exerted by a related party include:

²⁵ SA 240, Appendix 1.

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence may also exist in some cases if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

A30. In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example:

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.
- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the related party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 20)

A31. The nature, timing and extent of the further audit procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.²⁶

A32. Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.
- Confirming the purposes, specific terms or amounts of the transactions with the related parties (this audit procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).
- Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' accounting records.

A33. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements

²⁶ SA 330 provides further guidance on considering the nature, timing and extent of further audit procedures. SA 240 establishes requirements and provides guidance on appropriate responses to assessed risks of material misstatement due to fraud.

I.380 Auditing Pronouncements

of SA 240, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

- Inquiries of, and discussion with, management and those charged with governance.
- Inquiries of the related party.
- Inspection of significant contracts with the related party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of employee whistle-blowing reports where these are retained.

A34. Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the SA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls,²⁷ the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

Communicating Newly Identified Related Party Information to the Engagement Team (Ref: Para. 22(a))

A35. Communicating promptly any newly identified related parties to the other members of the engagement team assists them in determining whether this information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: Para. 22(c))

A36. Examples of substantive audit procedures that the auditor may perform relating to newly identified related parties or significant related party transactions include:

- Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, guarantors, or other close business partners.
- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.
- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been appropriately accounted for and disclosed in accordance with the

²⁷ SA 330, paragraph 8(b).

applicable financial reporting framework.

Intentional Non-Disclosure by Management (Ref: Para. 22(e))

A37. The requirements and guidance in SA 240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

Evaluating the Business Rationale of Significant Related Party Transactions (Ref: Para. 23)

A38. In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following:

- Whether the transaction:
 - Is overly complex (e.g., it may involve multiple related parties within a consolidated group).
 - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
 - Lacks an apparent logical business reason for its occurrence.
 - Involves previously unidentified related parties.
 - Is processed in an unusual manner.
- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.
- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with SA 500,²⁸ to consider the reliability of management's explanations and representations on other significant matters.

A39. The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Authorization and Approval of Significant Related Party Transactions (Ref: Para. 23(b))

A40. Authorisation and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorisation and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to error or fraud. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorisation and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorisation and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to

²⁸ SA 500, "Audit Evidence", paragraph 11.

the dominant influence of a related party.

Considerations specific to smaller entities

A41. A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction (Ref: Para. 24)

A42. Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, there are ordinarily practical difficulties that limit the auditor's ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.

A43. Management is responsible for the substantiation of an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Management's support for the assertion may include:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

A44. Evaluating management's support for this assertion may involve one or more of the following:

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

A45. Some financial reporting frameworks require the disclosure of related party transactions not conducted on terms equivalent to those prevailing in arm's length transactions. In these circumstances, if management has not disclosed a related party transaction in the financial statements, there may be an implicit assertion that the transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

Materiality Considerations in Evaluating Misstatements (Ref: Para. 25)

A46. SA 450 requires the auditor to consider both the size and the nature of a misstatement, and the

particular circumstances of its occurrence, when evaluating whether the misstatement is material.²⁹ The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.

Evaluation of Related Party Disclosures (Ref: Para. 25(a))

A47. Evaluating the related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

- (a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or
- (b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

Written Representations (Ref: Para. 26)

A48. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
- When they have made specific oral representations to the auditor on details of certain related party transactions.
- When they have financial or other interests in the related parties or the related party transactions.
- Management's assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction.

A49. The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

Communication with Those Charged with Governance (Ref: Para. 27)

A50. Communicating significant matters arising during the audit³⁰ in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include:

- Non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware.
- The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud.
- Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable financial reporting framework.

²⁹ SA 450, "Evaluation of Misstatements Identified during the Audit," paragraph 11(a). Paragraph A16 of SA 450 provides guidance on the circumstances that may affect the evaluation of a misstatement.

³⁰ SA 230, "Audit Documentation", paragraph A8 provides further guidance on the nature of significant matters arising during the audit.

I.384 Auditing Pronouncements

- Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions.
- Difficulties in identifying the party that ultimately controls the entity.

Material Modifications *vis a vis* ISA 550, “Related Parties”

Additions

1. In paragraph A20 of the Application Section, the lines, “Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists” have been added so to explain the difference between the control environment in the larger entities and smaller entities.
2. In paragraph A48 of the Application Section, it has been added that a written representation may be obtained by the auditor regarding management’s assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm’s length transaction.

Deletions

1. Paragraph A8 of the Application Section of ISA 550 deals with the application of the requirement of ISA 550 to the audits of public sector entities regarding the effect of laws and regulations governing the public sector bodies on the auditor’s responsibilities with regard to related party relationships and transactions. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of certain entities, the laws and regulations may also include a broader responsibility to address the risks of non-compliance with laws and regulations that lay down specific requirements in the conduct of business with related parties. Accordingly, the spirit of erstwhile A8, highlighting such additional responsibilities of the auditor, has been retained.

SA 560*
Subsequent Events
***(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. (Ref: Para. A1)
2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks¹ specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:
 - (a) Those that provide evidence of conditions that existed at the date of the financial statements; and
 - (b) Those that provide evidence of conditions that arose after the date of the financial statements.

SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.²

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

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

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Date of the financial statements – The date of the end of the latest period covered by the financial statements.
 - (b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)

* Published in January, 2009 issue of the Journal.

¹ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", Paragraph 13 (a).

² Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; paragraph A37.

I.386 Auditing Pronouncements

- (c) Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with SA 700. (Ref: Para. A3)
- (d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties. (Ref: Para. A4-A5)
- (e) Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Requirements

Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report

6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)

7. The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7-A8)

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)
- (c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available. (Ref: Para. A10)
- (d) Reading the entity's latest subsequent interim financial statements, if any.

8. When, as a result of the procedures performed as required by paragraphs 6 and 7, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Written Representations

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

10. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: (Ref: Para. A11)

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,

- (c) Inquire how management intends to address the matter in the financial statements.
11. If management amends the financial statements, the auditor shall:
- (a) Carry out the audit procedures necessary in the circumstances on the amendment.
 - (b) Unless the circumstances in paragraph 12 apply:
 - (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report; and
 - (ii) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.
12. When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases, the auditor shall either:
- (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or (*Ref: Para. A12*)
 - (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph³ that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.
13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: (*Ref: Para. A13-A14*)
- (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705⁴ and then provide the auditor's report; or
 - (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report. (*Ref: Para. A15-A16*)

Facts Which Become Known to the Auditor After the Financial Statements have been Issued

14. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
- (a) Discuss the matter with management and, where appropriate, those charged with governance.
 - (b) Determine whether the financial statements need amendment and, if so,

³ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

I.388 Auditing Pronouncements

- (c) Inquire how management intends to address the matter in the financial statements.
15. If the management amends the financial statements, the auditor shall: (Ref: Para. A17)
- (a) Carry out the audit procedures necessary in the circumstances on the amendment.
- (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
- (c) Unless the circumstances in paragraph 12 apply:
- (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report, and the date the new auditor's report no earlier than the date of approval of the amended financial statements; and
- (ii) Provide a new auditor's report on the amended financial statements.
- (d) When the circumstances in paragraph 12 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.
16. The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance⁵ are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref: Para. A18)

Application and Other Explanatory Material

Introduction (Ref: Para. 1)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

Definitions

Date of Approval of the Financial Statements (Ref: Para. 5(b))

A2. In some entities, the applicable law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In some other entities, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalising its financial statements in view

⁵ SA 260, paragraph 12(c).

of its management and governance structures. In some cases, final approval of the financial statements by shareholders is required. In such cases, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the SAs is the earlier date on which those with the recognised authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements.

Date of the Auditor's Report (Ref: Para. 5(c))

A3. The auditor's report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements.⁶ Consequently, the date of the auditor's report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor's report as defined in paragraph 5(c) and the date the auditor's report is provided to the entity.

Date the Financial Statements are Issued (Ref: Para. 5(d))

A4. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

A5. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public.

Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report (Ref: Para. 6-9)

A6. Depending on the auditor's risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cut-off procedures or procedures in relation to subsequent receipts of accounts receivable).

A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. When the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records,

⁶ SA 700, paragraph 41.

I.390 Auditing Pronouncements

including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.

A8. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:

- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;
- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

Inquiry (Ref: Para. 7(b))

A9. In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

Reading Minutes (Ref: Para. 7(c))

A10. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

Management Responsibility Towards Auditor (Ref: Para. 10)

A11. As explained in SA 210, the terms of the audit engagement include the agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware

during the period from the date of the auditor's report to the date the financial statements are issued.⁷

Dual Dating (Ref: Para. 12(a))

A12. When, in the circumstances described in paragraph 12(a), the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements. The following is an illustration of such an additional date:

“(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)”.

No Amendment of Financial Statements by Management (Ref: Para. 13)

A13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements.

A14. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the actions taken in accordance with paragraph 13 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 13(b))

A15. The auditor may need to fulfill additional legal obligations even when the auditor has notified management not to issue the financial statements and management has agreed to this request.

A16. When management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor's course of action to prevent reliance on the auditor's report on the financial statements depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

Facts Which Become Known to the Auditor After the Financial Statements have been Issued

No Amendment of Financial Statements by Management (Ref: Para. 15)

A17. In some circumstances, the entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 17)

A18. When the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

⁷ SA 210, "Agreeing the Terms of Audit Engagements", paragraph A23.

Material Modifications to ISA 560, “Subsequent Events”

Deletion

1. Paragraph A5 of ISA 560 provides that in the case of public sector entities, the date the financial statements are issued may be the date the audited financial statements and the auditor’s report thereon are presented to the legislature or otherwise made public. Paragraph A10 of ISA 560 provides that in the case of public sector, the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available. Paragraph A14 of ISA 560 provides that in the case of public sector, the actions taken in accordance with paragraph 13 of ISA when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor’s report. Paragraph A17 of ISA 560 provides that in some circumstances, the entities in the public sector may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such situations may also exist in case of certain entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A5, A10, A14 and A17, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

SA 570*
Going Concern
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2017)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report. (Ref: Para. A1)

Going Concern Basis of Accounting

2. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis). When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A2)

Responsibility for Assessment of the Entity's Ability to Continue as a Going Concern

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, where the going concern basis of accounting is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

5. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.

* Published in October, 2008 issue of the Journal.

I.394 Auditing Pronouncements

- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the Auditor

6. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

7. However, as described in SA 200,¹ the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

9. The objectives of the auditor are:
- (a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
 - (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
 - (c) To report in accordance with this SA.

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by SA 315,² the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and: (Ref: Para. A3–A6)

- (a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going

¹ SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraphs A51–A52

² SA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 5

concern and, if so, management's plans to address them; or

- (b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

11. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A7)

Evaluating Management's Assessment

12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. (Ref: Para. A8–A10, A12–A13)

13. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements as defined in SA 560,3 the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A11–A13)

14. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

Period beyond Management's Assessment

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A14–A15)

Additional Audit Procedures When Events or Conditions Are Identified

16. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (hereinafter referred to as "material uncertainty") through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: (Ref: Para. A16)

- (a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- (b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances. (Ref: Para. A17)
- (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions: (Ref: Para. A18–A19)
 - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
 - (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
- (d) Considering whether any additional facts or information have become available since the date on which

³ SA 560, *Subsequent Events*, paragraph 5(a)

management made its assessment.

- (e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans. (Ref: Para. A20)

Auditor Conclusions

17. The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

18. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (Ref: Para. A21–A22)

- (a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or
- (b) In the case of a compliance framework, the financial statements not to be misleading.

Adequacy of Disclosures When Events or Conditions Have Been Identified and a Material Uncertainty Exists

19. If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: (Ref: Para. A22–A23)

- (a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- (b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists

20. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. (Ref: Para. A24–A25)

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting Is Inappropriate

21. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A26–A27)

Use of Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements

22. If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to: (Ref: Para. A28–A31, A34)

- (a) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19; and
- (b) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements

23. If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall: (Ref: Para. A32–A34)

- (a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised)⁴; and
- (b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Management Unwilling to Make or Extend Its Assessment

24. If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. (Ref: Para. A35)

Communication with Those Charged with Governance

25. Unless all those charged with governance are involved in managing the entity,⁵ the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

- (a) Whether the events or conditions constitute a material uncertainty;
- (b) Whether management's use of the going concern basis of accounting is appropriate in the preparation of the financial statements;
- (c) The adequacy of related disclosures in the financial statements; and
- (d) Where applicable, the implications for the auditor's report.

Significant Delay in the Approval of Financial Statements

26. If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as described in paragraph 16, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 18.

Application and Other Explanatory Material

Scope of this SA (Ref: Para 1)

A1. SA 701⁶ deals with the auditor's responsibility to communicate key audit matters in the auditor's report.

⁴ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

⁵ SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13.

⁶ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

That SA acknowledges that, when SA 701 applies, matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a key audit matter.⁷

Going Concern Basis of Accounting (Ref: Para. 2)

Considerations Specific to Public Sector Entities

A2. Management's use of the going concern basis of accounting is also relevant to public sector entities. Going concern risks may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatization. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity.

Risk Assessment Procedures and Related Activities

Events or Conditions That May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern (Ref: Para. 10)

A3. The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.

⁷ See paragraphs 15 and A41 of SA 701.

- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

A4. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern basis of accounting is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Considerations Specific to Smaller Entities (Ref: Para. 10)

A5. The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

A6. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.

Remaining Alert throughout the Audit for Audit Evidence about Events or Conditions (Ref: Para. 11)

A7. SA 315 requires the auditor to revise the auditor's risk assessment and modify the further planned audit procedures accordingly when additional audit evidence is obtained during the course of the audit that affects the auditor's assessment of risk.⁸ If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, in addition to performing the procedures in paragraph 16, the auditor's assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks. SA 330⁹ establishes requirements and provides guidance on this issue.

Evaluating Management's Assessment

Management's Assessment and Supporting Analysis and the Auditor's Evaluation (Ref: Para. 12)

A8. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.

A9. It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is

⁸ SA 315, paragraph 31

⁹ SA 330, *The Auditor's Responses to Assessed Risks*

I.400 Auditing Pronouncements

appropriate in the circumstances. For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.

A10. In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, as required by paragraph 12, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.

The Period of Management's Assessment (Ref: Para. 13)

A11. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.

Considerations Specific to Smaller Entities (Ref: Para. 12–13)

A12. In many cases, the management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, in accordance with the requirements of this SA, the auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern. For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management's contentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity. Therefore, the requirement in paragraph 13 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, for example, orders received for future supply, evaluated as to their feasibility or otherwise substantiated.

A13. Continued support by owner-managers is often important to smaller entities' ability to continue as a going concern. Where a small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating a loan to the entity in favor of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances, the auditor may obtain appropriate documentary evidence of the subordination of the owner-manager's loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, the auditor may evaluate the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may request written confirmation of the terms and conditions attaching to such support and the owner-manager's intention or understanding.

Period beyond Management's Assessment (Ref: Para. 15)

A14. As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern. In these circumstances, the procedures in

paragraph 16 apply.

A15. Other than inquiry of management, the auditor does not have a responsibility to perform any other audit procedures to identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management, which, as discussed in paragraph 13, would be at least twelve months from the date of the financial statements.

Additional Audit Procedures When Events or Conditions Are Identified (Ref: Para.16)

A16. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

Evaluating Management's Plans for Future Actions (Ref: Para. 16(b))

A17. Evaluating management's plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

The Period of Management's Assessment (Ref: Para. 16(c))

A18. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A19. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

Written Representations (Ref: Para. 16(e))

A20. The auditor may consider it appropriate to obtain specific written representations beyond those

I.402 Auditing Pronouncements

required in paragraph 16 in support of audit evidence obtained regarding management's plans for future actions in relation to its going concern assessment and the feasibility of those plans.

Auditor Conclusions

Material Uncertainty Related to Events or Conditions that May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern (Ref: Para. 18-19)

A21. The phrase "material uncertainty" means the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

Adequacy of Disclosure when Events or Conditions Have Been Identified and a Material Uncertainty Exists

A22. Paragraph 18 explains that a material uncertainty exists when the magnitude of the potential impact of the events or conditions and the likelihood of occurrence is such that appropriate disclosure is necessary to achieve fair presentation (for fair presentation frameworks) or for the financial statements not to be misleading (for compliance frameworks). The auditor is required by paragraph 18 to conclude whether such a material uncertainty exists regardless of whether or how the applicable financial reporting framework defines a material uncertainty.

A23. Paragraph 19 requires the auditor to determine whether the financial statement disclosures address the matters set forth in that paragraph. This determination is in addition to the auditor determining whether disclosures about a material uncertainty, required by the applicable financial reporting framework, are adequate. Disclosures required by some financial reporting frameworks that are in addition to matters set forth in paragraph 19 may include disclosures about:

- Management's evaluation of the significance of the events or conditions relating to the entity's ability to meet its obligations; or
- Significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

Some financial reporting frameworks may provide additional guidance regarding management's consideration of disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of their occurrence.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists (Ref: Para. 20)

A24. Even when no material uncertainty exists, paragraph 20 requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Some financial reporting frameworks may address disclosures about:

- Principal events or conditions;
- Management's evaluation of the significance of those events or conditions in relation to the entity's ability to meet its obligations;
- Management's plans that mitigate the effect of these events or conditions; or
- Significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

A25. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation includes the

consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.¹⁰ Depending on the facts and circumstances, the auditor may determine that additional disclosures are necessary to achieve fair presentation. This may be the case, for example, when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained, the auditor concludes that no material uncertainty exists, and no disclosures are explicitly required by the applicable financial reporting framework regarding these circumstances.

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting is Inappropriate (Ref: Para. 21)

A26. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the financial statements is inappropriate, the requirement in paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting.

A27. When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in accordance with SA 706 (Revised)¹¹ in the auditor's report to draw the user's attention to that alternative basis of accounting and the reasons for its use.

Use of the Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists (Ref: Para. 22-23)

A28. The identification of a material uncertainty is a matter that is important to users' understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.

A29. The Appendix to this SA provides illustrations of the statements that are required to be included in the auditor's report on the financial statements when "the Accounting Principles generally accepted in India" is the applicable financial reporting framework. If an applicable financial reporting framework other than above-mentioned framework is used, the illustrative statements presented in the Appendix to this SA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

A30. Paragraph 22 establishes the minimum information required to be presented in the auditor's report in each of the circumstances described. The auditor may provide additional information to supplement the required statements, for example to explain:

- That the existence of a material uncertainty is fundamental to users' understanding of the financial statements;¹² or

¹⁰ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 14

¹¹ SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

¹² SA 706(Revised), paragraph A2

I.404 Auditing Pronouncements

- How the matter was addressed in the audit. (Ref: Para. A1)

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements (Ref: Para. 22)

A31. Illustration 1 of the Appendix to this SA is an example of an auditor's report when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern basis of accounting but a material uncertainty exists and disclosure is adequate in the financial statements. The Appendix of SA 700 (Revised) also includes illustrative wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements (Ref: Para. 23)

A32. Illustrations 2 and 3 of the Appendix to this SA are examples of auditor's reports containing qualified and adverse opinions, respectively, when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of the management's use of the going concern basis of accounting but adequate disclosure of a material uncertainty is not made in the financial statements.

A33. In situations involving multiple uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of including the statements required by paragraph 22. SA 705 (Revised) provides guidance on this issue.¹³

Communication with Regulators (Ref: Para. 22–23)

A34. When the auditor of a regulated entity considers that it may be necessary to include a reference to going concern matters in the auditor's report, the auditor may have a duty to communicate with the applicable regulatory, enforcement or supervisory authorities.

Management Unwilling to Make or Extend Its Assessment (Ref: Para. 24)

A35. In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

Appendix

(Ref: Para. A29, A31–A32)

Illustrations of Auditor's Reports Relating to Going Concern

- Illustration 1: An auditor's report containing an unmodified opinion when the auditor has concluded that a material uncertainty exists and disclosure in the financial statements is adequate.
- Illustration 2: An auditor's report containing a qualified opinion when the auditor has concluded that a material uncertainty exists and that the financial statements are materially misstated due to inadequate disclosure.
- Illustration 3: An auditor's report containing an adverse opinion when the auditor has concluded that a material uncertainty exists and the financial statements omit the required disclosures relating to a material uncertainty.

¹³ SA 705(Revised), paragraph 10

Illustration 1 – Unmodified Opinion When a Material Uncertainty Exists and Disclosure in the Financial Statements Is Adequate

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.14
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. The disclosure of the material uncertainty in the financial statements is adequate.
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹⁵**Opinion**

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)¹⁶ and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)]¹⁷.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)¹⁸ and its cash flows for the year ended on that date.

Basis for Opinion

¹⁴ SA 210, *Agreeing the Terms of Audit Engagements*

¹⁵ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁶ Where applicable.

¹⁷ Where applicable.

¹⁸ Where applicable

I.406 Auditing Pronouncements

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the *Code of Ethics* issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note XX in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note XX, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Material Uncertainty Related to Going Concern* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with SA 701.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised)—see Illustration 1 in SA 700 (Revised).¹⁹]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation²⁰)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁹ Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

²⁰ Partner or Proprietor, as the case may be

Illustration 2 – Qualified Opinion When a Material Uncertainty Exists and the Financial Statements Are Materially Misstated Due to Inadequate Disclosure

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Note YY to the financial statements discusses the magnitude of financing arrangements, the expiration and the total financing arrangements; however the financial statements do not include discussion on the impact or the availability of refinancing or characterize this situation as a material uncertainty.
- The financial statements are materially misstated due to the inadequate disclosure of the material uncertainty. A qualified opinion is being expressed because the auditor concluded that the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements²¹

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)²² and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)]²³.

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India,

²¹ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²² Where applicable.

²³ Where applicable.

I.408 Auditing Pronouncements

of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)²⁴ and its cash flows for the year ended on that date.

Basis for Qualified Opinion

As discussed in Note YY, the Company's financing arrangements expire and amounts outstanding are payable on April 30, 20X2. The Company has been unable to conclude re-negotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this matter.

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the *Code of Ethics* issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Descriptions of each key audit matter in accordance with SA 701.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).²⁵]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation²⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

²⁴ Where applicable

²⁵ Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

²⁶ Partner or Proprietor, as the case may be

Illustration 3 – Adverse Opinion When a Material Uncertainty Exists and Is Not Disclosed in the Financial Statements

For purposes of the illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a non corporate entity using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements omit the required disclosures relating to the material uncertainty. An adverse opinion is being expressed because the effects on the financial statements of such omission are material and pervasive.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Partners of ABC & Associates [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements²⁷**Adverse Opinion**

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet at March 31st 20XX, and the profit and loss account, (*and statement of cash flows*)²⁸ for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the omission of the information mentioned in the *Basis for Adverse Opinion* section of our report, the accompanying financial statements do not present fairly (*or do not give a true and fair view of*), the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The entity's financing arrangements expired and the amount outstanding was payable on March 31, 20X1. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

²⁷ The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²⁸ Where applicable.

I.410 Auditing Pronouncements

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) issued by ICAI. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements²⁹

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).³⁰]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation³¹)
(Membership No. XXXXX)

Place of Signature:

Date:

²⁹ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

³⁰ Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

³¹ Partner or Proprietor, as the case may be

SA 580*

Written Representations
***(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

Written Representations as Audit Evidence

2. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based.¹ Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. (*Ref: Para. A1*)
3. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

Objectives

5. The objectives of the auditor are:
 - (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
 - (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
 - (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Definition

6. For purposes of the SAs, the following term has the meaning attributed below:

* Published in October, 2008 issue of the Journal.

¹ SA 500, "Audit Evidence", paragraph 5 (c).

I.412 Auditing Pronouncements

Written representations – A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

7. For purposes of this SA, references to “management” should be read as “management and, where appropriate, those charged with governance.” Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and *fair* presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the applicable financial reporting framework.

Requirements

Management from Whom Written Representations Requested

8. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2-A6)

Written Representations about Management’s Responsibilities

Preparation of the Financial Statements

9. The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.² (Ref: Para. A7-A9, A14, A22)

Information Provided and Completeness of Transactions

10. The auditor shall request management to provide a written representation that:
 - (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement,³ and
 - (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)

Description of Management’s Responsibilities in the Written Representations

11. Management’s responsibilities shall be described in the written representations required by paragraphs 9 and 10 in the manner in which these responsibilities are described in the terms of the audit engagement.

Other Written Representations

12. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10-A13, A14, A22)

Date of and Period(s) Covered by Written Representations

13. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor’s report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor’s report. (Ref: Para. A15-A18)

² SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b)(i)

³ SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b)(iii).

Form of Written Representations

14. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 9 or 10, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19-A21)

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

Doubt as to the Reliability of Written Representations

15. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24-A25)
16. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A23)
17. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705⁴, having regard to the requirement in paragraph 19 of this SA.

Requested Written Representations Not Provided

18. If management does not provide one or more of the requested written representations, the auditor shall:
- (a) Discuss the matter with management;
 - (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
 - (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, having regard to the requirement in paragraph 19 of this SA.

Written Representations about Management's Responsibilities

19. The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if: (Ref: Para. A26-A27)
- (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 9 and 10 are not reliable; or
 - (b) Management does not provide the written representations required by paragraphs 9 and 10.

Application and Other Explanatory Material

Written Representations as Audit Evidence (Ref: Para. 2)

- A1. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more

⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

I.414 Auditing Pronouncements

significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Management from Whom Written Representations Requested (Ref: Para. 8)

- A2. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.
- A3. Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.
- A4. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:
- An actuary responsible for actuarially determined accounting measurements.
 - Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
 - Internal counsel who may provide information essential to provisions for legal claims.
- A5. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
- A6. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations, confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

Written Representations about Management's Responsibilities (Ref: Para. 9-10)

- A7. Audit evidence obtained during the audit that management has fulfilled the responsibilities referred to in paragraphs 10 and 11 is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.
- A8. The written representations required by paragraphs 9 and 10 draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by

requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

Consistent with the requirement of SA 210,⁵ such reconfirmation of management's acknowledgement and understanding of its responsibilities is not made subject to the best of management's knowledge and belief (as discussed in paragraph A5 of this SA).

A9. The mandates for audits of the financial statements of certain entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may give rise to additional written representations. These may include written representations confirming that transactions and events have been carried out in accordance with legislation or proper authority.

Other Written Representations (Ref: Para. 12)

Additional Written Representations about the Financial Statements

A10. In addition to the written representation required by paragraph 9, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation required by paragraph 9. They may include representations about the following:

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
 - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
 - Liabilities, both actual and contingent;
 - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
 - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

Additional Written Representations about Information Provided to the Auditor

A11. In addition to the written representation required by paragraph 10, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

⁵ SA 210, "Agreeing the Terms of Audit Engagements," paragraph 6(b).

I.416 Auditing Pronouncements

Written Representations about Specific Assertions

A12. When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

A13. In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

Communicating a Threshold Amount (Ref: Para. 9-10, 12)

A14. SA 450⁶ requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. The auditor may determine a threshold above which misstatements cannot be regarded as clearly trivial. In the same way, the auditor may consider communicating to management a threshold for purposes of the requested written representations.

Date of and Period(s) Covered by Written Representations (Ref: Para. 13)

A15. Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

A16. In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

A17. The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

A18. Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the

⁶ SA 450, "Evaluation of Misstatements Identified during the Audit", paragraph 5.

requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Form of Written Representations (Ref: Para. 14)

A19. Written representations are required to be included in a representation letter addressed to the auditor. Some laws or regulations may, however, require management to make a written public statement about its responsibilities. Although such statement is a representation to the users of the financial statements, or to relevant authorities, the auditor may determine that it is an appropriate form of written representation in respect of some or all of the representations required by paragraph 9 or 10. Consequently, the relevant matters covered by such statement need not be included in the representation letter. Factors that may affect the auditor's determination include:

- Whether the statement includes confirmation of the fulfillment of the responsibilities referred to in paragraphs 10 and 11.
- Whether the statement has been given or approved by those from whom the auditor requests the relevant written representations.
- Whether a copy of the statement is provided to the auditor as near as practicable to, but not after, the date of the auditor's report on the financial statements (see paragraph 13).

A20. A formal statement of compliance with law or regulation, or of approval of the financial statements, would not contain sufficient information for the auditor to be satisfied that all necessary representations have been consciously made. The expression of management's responsibilities in law or regulation is also not a substitute for the requested written representations.

A21. The Appendix to this Standard provides an illustrative example of a representation letter.

Communication with Those Charged with Governance (Ref: Para. 9-10, 12)

A22. SA 260⁷ requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.

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

Doubt as to the Reliability of Written Representations (Ref: Para. 15-16)

A23. In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

A24. Concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider, where possible, withdrawing from the engagement, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

A25. SA 230⁸ requires the auditor to document significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. The

⁷ SA 260, "Communication with Those Charged with Governance", paragraph 12(c)(ii).

⁸ SA 230, "Audit Documentation", refer paragraph 8 and 10.

I.418 Auditing Pronouncements

auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with SA 230.

Written Representations about Management's Responsibilities (Ref: Para. 19)

A26. As explained in paragraph A7, the auditor is not able to judge solely on other audit evidence whether management has fulfilled the responsibilities referred to in paragraphs 10 and 11. Therefore, if, as described in paragraph 19(a), the auditor concludes that the written representations about these matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. SA 705 requires the auditor to disclaim an opinion on the financial statements in such circumstances.⁹

A27. A written representation that has been modified from that requested by the auditor does not necessarily mean that management did not provide the written representation. However, the underlying reason for such modification may affect the opinion in the auditor's report. For example:

- The written representation about management's fulfillment of its responsibility for the preparation and presentation of the financial statements may state that management believes that, except for material non-compliance with a particular requirement of the applicable financial reporting framework, the financial statements are prepared and presented in accordance with that framework. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effect of the non-compliance on the opinion in the auditor's report in accordance with SA 705.
- The written representation about the responsibility of management to provide the auditor with all relevant information agreed in the terms of the audit engagement may state that management believes that, except for information destroyed in a fire, it has provided the auditor with such information. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor's report in accordance with SA 705.

Material Modifications to ISA 580, "Written Representations"

Deletions

Paragraph A9 of the Application Section of ISA 580 deals with the application of the requirements of ISA 580 to the audits of public sector entities regarding the premise, relating to management's responsibilities which may give rise to additional written representations. Since as mentioned in the *"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"*, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Since it is also possible that even in case of non public sector entities, management responsibilities may give rise to additional representations, accordingly, the spirit of erstwhile A9, highlighting the fact that in case of certain entities, the need of additional representations may arise, has been retained.

⁹ SA 705, paragraph 9.

Appendix

(Ref: Para. A23)

Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other SAs in effect for audits of financial statements for period beginning on or after as at [date]. It is assumed in this illustration that the applicable financial reporting framework is applicable accounting standards in India; the requirement of SA 570¹⁰ to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended March 31, 20XX¹¹ for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with the applicable accounting standards in India.

We confirm that (*to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with Financial Reporting Standards; in particular the financial statements are fairly presented (or *give a true and fair view*) in accordance with the applicable accounting standards in India.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (SA 540)
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)¹²
- All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)
- [Any other matters that the auditor may consider appropriate (see paragraph A10 of this SA).]

Information Provided

- We have provided you with:

¹⁰ SA 570, "Going Concern".

¹¹ Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

¹² SA 550, "Related Parties".

I.420 Auditing Pronouncements

- Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
- Additional information that you have requested from us for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (SA 240).
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
 - Management;
 - Employees who have significant roles in internal control; or
 - Others where the fraud could have a material effect on the financial statements. (SA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (SA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (SA 250)¹³
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (SA 550)¹⁴
- [Any other matters that the auditor may consider necessary (see paragraph A11 of this SA).]

Management

Management

¹³ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

¹⁴ SA 550, "Related Parties".

SA 600

Using the Work of Another Auditor

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2002)*

Introduction

1. The Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", states (paragraph 9):
"When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance."
2. The purpose of this Standard on Auditing (SA) is to establish standards to be applied in situations where an auditor (referred to herein as the 'principal auditor'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the 'other auditor') with respect to the financial information of one or more components included in the financial information of the entity. This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Standard, the term 'financial information' encompasses 'financial statements'.
3. This Standard does not deal with those instances where two or more auditors are appointed as joint auditors¹ nor does it deal with the auditor's relationship with a predecessor auditor.
4. When the principal auditor concludes that the financial information of a component is immaterial, the procedures outlined in this Statement do not apply. When several components, immaterial in themselves, are together material in relation to the financial information of the entity as a whole, the procedures outlined in this Statement should be considered.
5. **When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.**
6. "Principal auditor" means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
7. "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.

¹ Standard on Auditing (SA) 299, "Responsibility of Joint Auditors", deals with the audit procedures to be employed where two or more auditors are appointed as joint auditors.

I.422 Auditing Pronouncements

8. "Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

Acceptance as Principal Auditor

9. **The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.** For this purpose the auditor would consider:

- (a) the materiality of the portion of the financial information which the principal auditor audits;
- (b) the principal auditor's degree of knowledge regarding the business of the components;
- (c) the risk of material misstatements in the financial information of the components audited by the other auditor; and
- (d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

The Principal Auditor's Procedures

10. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

11. **When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.**

12. **The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.** When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

13. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

14. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 13 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

15. The principal auditor should consider the significant findings of the other auditor.

16. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

17. In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined in paragraphs 10 to 16 assume added importance.

18. The principal auditor should document in his working papers the components whose financial information was audited by other auditors; their significance to the financial information of the entity as a whole; the names of the other auditors; and any conclusions reached that individual components are not material. The principal auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described at 14 above, provided those reasons are summarised elsewhere in the documentation maintained by the principal auditor. Where the other auditor's report is other than unmodified², the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

Co-ordination Between Auditors

19. **There should be sufficient liaison between the principal auditor and the other auditor.** For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

20. **The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.** For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

21. When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

² Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:

"Matters that do not affect the auditor's opinion

(a) emphasis of matter

Matters that do affect the auditor's opinion

(a) qualified opinion,

(b) disclaimer of opinion, or

(c) adverse opinion".

Reporting Considerations

22. **When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.**

23. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

Division of Responsibility

24. The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

25. **When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.**

Effective Date

26. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 2002.

Compatibility with International Standard on Auditing (ISA) 600

The auditing standards established in this Standard on Auditing (SA) are generally consistent, in all material respects, with those set out in ISA 600 "Using the Work of Another Auditor".

SA 610*

Using the Work of Internal Auditors
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2016)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.
2. This SA does not apply if the entity does not have an internal audit function. (Ref: Para. A2)
3. If the entity has an internal audit function, the requirements in this SA relating to using the work of that function do not apply if:
 - (a) The responsibilities and activities of the function are not relevant to the audit; or
 - (b) Based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under SA 315,¹ the external auditor does not expect to use the work of the function in obtaining audit evidence.

Nothing in this SA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy.

4. Furthermore, the requirements in this SA relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.
5. In some cases, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function or using internal auditors to provide direct assistance. The SAs do not override laws or regulations that govern an audit of financial statements.² Such prohibitions or restrictions will therefore not prevent the external auditor from complying with the SAs. (Ref: Para. A31)

* Published in August, 2009 issue of the Journal.

¹ Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document.

² SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraph A55.

Relationship between SA 315 and SA 610 (Revised)

6. Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

7. SA 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. SA 315³ also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

8. Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner. This SA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under SA 315, the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained⁴. Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.

9. In addition, this SA also addresses the external auditor's responsibilities if considering using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

10. There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered internal controls and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with SA 330⁵.

The External Auditor's Responsibility for the Audit

11. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200⁶. This SA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is

³ Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document. (Para A116 of SA 315 in those conforming amendments)

⁴ See paragraphs 15–25

⁵ SA 330, The Auditor's Responses to Assessed Risks.

⁶ SA 200, paragraph 14.

adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

Effective Date

12. This SA is effective for audits of financial statements for periods beginning on or after 01st April, 2016.

Objectives

13. The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

- (a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination:
- (b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- (c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Definitions

14. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes. (Ref: Para. A1–A4)
- (b) Direct assistance – The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Requirements

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

15. The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

- (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: Para. A5–A9)
- (b) The level of competence of the internal audit function; and (Ref: Para. A5–A9)
- (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A10–A11)

16. The external auditor shall not use the work of the internal audit function if the external auditor determines that:

- (a) The function's organizational status and relevant policies and procedures do not adequately support

I.428 Auditing Pronouncements

the objectivity of internal auditors;

- (b) The function lacks sufficient competence; or
- (c) The function does not apply a systematic and disciplined approach, including quality control. (Ref: Para. A12–A14)

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

17. As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan. (Ref: Para. A15–A17)

18. The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly: (Ref: Para. A15–A17)

- (a) The more judgment is involved in:
 - (i) Planning and performing relevant audit procedures; and
 - (ii) Evaluating the audit evidence gathered; (Ref: Para. A18–A19)
- (b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant; (Ref: Para. A20–A22)
- (c) The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
- (d) The lower the level of competence of the internal audit function.

19. The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. (Ref: Para. A15–A22)

20. The external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with SA 260⁷, communicate how the external auditor has planned to use the work of the internal audit function. (Ref: Para. A23)

Using the Work of the Internal Audit Function

21. If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref: Para. A24–A26)

22. The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

23. The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:

⁷ SA 260, Communication with Those Charged with Governance, paragraph 11.

- (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;
 - (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
 - (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref: Para. A27–A30)
24. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:
- (a) The amount of judgment involved;
 - (b) The assessed risk of material misstatement;
 - (c) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and
 - (d) The level of competence of the function;⁸ (Ref: Para. A27–A29) and shall include reperformance of some of the work. (Ref: Para. A30)
25. The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function in paragraph 15 of this SA and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs 18–19 of this SA remain appropriate.

Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit

26. The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. If so, paragraphs 27–35 and 37 do not apply. (Ref: Para. A31)
27. If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity. (Ref: Para. A32–A34)
28. The external auditor shall not use an internal auditor to provide direct assistance if:
- (a) There are significant threats to the objectivity of the internal auditor; or
 - (b) The internal auditor lacks sufficient competence to perform the proposed work. (Ref: Para. A32–A34)

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

⁸ See paragraph 18.

I.430 Auditing Pronouncements

29. In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

- (a) The amount of judgment involved in:
 - (i) Planning and performing relevant audit procedures; and
 - (ii) Evaluating the audit evidence gathered;
- (b) The assessed risk of material misstatement; and
- (c) The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance. (Ref: Para. A35–A39)

30. The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

- (a) Involve making significant judgments in the audit; (Ref: Para. A19)
- (b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited; (Ref: Para. A38)
- (c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- (d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance. (Ref: Para. A35–A39)

31. Having appropriately evaluated whether and, if so, to what extent internal auditors can be used to provide direct assistance on the audit, the external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with SA 260,⁹ communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. (Ref: Para. A39)

32. The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

Using Internal Auditors to Provide Direct Assistance

33. Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:

- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

⁹ SA 260, paragraph 11.

34. The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220¹⁰. In doing:

- (a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this SA; and
- (b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work. (Ref: Para. A40–A41)

35. In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations in paragraph 27 are no longer appropriate.

Documentation

36. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

- (a) The evaluation of:
 - (i) Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
 - (ii) The level of competence of the function; and
 - (iii) Whether the function applies a systematic and disciplined approach, including quality control;
- (b) The nature and extent of the work used and the basis for that decision; and
- (c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

37. If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include in the audit documentation:

- (a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- (b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- (c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230¹¹;
- (d) The written agreements obtained from an authorized representative of the entity and the internal auditors under paragraph 33 of this SA; and
- (e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

¹⁰ SA 220, Quality Control for an Audit of Financial Statements.

¹¹ SA 230, Audit Documentation.

Application and Other Explanatory Material

Definition of Internal Audit Function (Ref: Para. 2, 14(a))

A1. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

Activities Relating to Governance

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Activities Relating to Risk Management

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

Activities Relating to Internal Control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

A2. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are sole determinants of whether or not the external auditor can use the work of the function. Rather, it is the nature of the activities; the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; competence; and systematic and disciplined approach of the function that are relevant. References in this SA

to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this SA, although they may perform control activities that can be tested in accordance with SA 330¹². For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

A4. While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, SA 315¹³ requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function); or
- Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor¹⁴.

In addition, unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance" in this SA)¹⁵.

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

Objectivity and Competence (Ref: Para. 15(a)–(b))

A5. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

A6. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

¹² See paragraph 10.

¹³ Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document. (please see SA 315, paragraph 6(a) therein)

¹⁴ See paragraphs 15–25.

¹⁵ See paragraphs 26–35

I.434 Auditing Pronouncements

A7. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:

- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
- Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.
- Whether those charged with governance oversee employment decisions related to the internal audit function, for example, determining the appropriate remuneration policy.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

A8. Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

A9. Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

Application of a Systematic and Disciplined Approach (Ref: Para. 15(c))

A10. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

A11. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and procedures in SQC 1¹⁶ that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: Para. 16)

A12. The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.

A13. Consideration of the factors in paragraphs A7, A8 and A11 of this SA individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity unless other factors such as those described in paragraph A7 of this SA collectively provide sufficient safeguards to reduce the threat to an acceptable level.

A14. In addition, a self-review threat¹⁷ is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. Paragraph 290.173 of the Code of Ethics, issued by the Institute of Chartered Accountants of India therefore in the context of provision of internal audit service to financial statement audit clients, specifically provides that "a statutory auditor of an entity cannot be its internal auditor as it will not be possible for him to give an independent and objective opinion". The said Code of Ethics discusses the threats and the safeguards that can be applied to reduce the threats to an acceptable level in other circumstances.

¹⁶ Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

¹⁷ Attention of the members is also invited to paragraph 2.1 of the Guidance Note on Independence of Auditors, issued by the Institute of Chartered Accountants of India.

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function that Can Be Used (Ref: Para. 17–19)

A15. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with SA 300¹⁸.¹⁸

A16. Examples of work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600)¹⁹.

A17. The external auditor's determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 18 of this SA. In addition, the amount of judgment needed in planning, performing and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, there are circumstances in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 16 of this SA.

Judgments in planning and performing audit procedures and evaluating results (Ref: Para. 18(a), 30(a))

A18. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly in accordance with paragraph 18 of this SA, because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

A19. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 18. Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;

¹⁸ SA 300, Planning an Audit of Financial Statements.

¹⁹ SA 600, Using the Work of Another Auditor.

- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

Assessed risk of material misstatement (Ref: Para. 18(b))

A20. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph 18 of this SA, and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200²⁰, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

A21. As explained in SA 315²¹, significant risks require special audit consideration and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

A22. Carrying out procedures in accordance with this SA may cause the external auditor to reevaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this SA is necessary.

Communication with Those Charged with Governance (Ref: Para. 20)

A23. In accordance with SA 260^{22, 22} the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

Using the Work of the Internal Audit Function

Discussion and Coordination with the Internal Audit Function (Ref: Para. 21)

A24. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.

²⁰ SA 200, paragraph A29.

²¹ SA 315, paragraph 4(e).

²² SA 260, paragraph 11.

I.438 Auditing Pronouncements

- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.
- Review and reporting procedures.

A25. Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

A26. SA 200²³ discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.²⁴ The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with SA 240²⁵.

Procedures to Determine the Adequacy of Work of the Internal Audit Function (Ref: Para. 23–24)

A27. The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed.

A28. The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 24, include the following:

- Making inquiries of appropriate individuals within the internal audit function.
- Observing procedures performed by the internal audit function.
- Reviewing the internal audit function's work program and working papers.

²³ SA 200, paragraphs 15 and A18.

²⁴ Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document. (please see SA 315, paragraph A116 therein).

²⁵ SA 315, paragraph A11 (as given in the conforming amendments) in relation to SA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.

A29. The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

Reperformance (Ref: Para. 24)

A30. For purposes of this SA, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function or, where it is not possible to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 24. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.

Determining Whether, in Which Areas and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit (Ref: Para. 5, 26–28)

A31. In case where the external auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the principal auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.

A32. As stated in paragraph A7 of this SA, objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments. In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:

- The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors²⁶.
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
- Association with the division or department in the entity to which the work relates.
- Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

Material issued by relevant professional bodies for internal auditors may provide additional useful guidance.

²⁶ See paragraph A7.

A33. There may also be some circumstances in which the significance of the threats to the objectivity of an internal auditor is such that there are no safeguards that could reduce them to an acceptable level. For example, because the adequacy of safeguards is influenced by the significance of the work in the context of the audit, paragraph 30(a) and (b) prohibits the use of internal auditors to provide direct assistance in relation to performing procedures that involve making significant judgments in the audit or that relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited. This would also be the case where the work involved creates a self-review threat, which is why internal auditors are prohibited from performing procedures in the circumstances described in paragraph 30(c) and (d).

A34. In evaluating the level of competence of an internal auditor, many of the factors in paragraph A8 of this SA may also be relevant, applied in the context of individual internal auditors and the work to which they may be assigned.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance (Ref: Para. 29–31)

A35. Paragraphs A15–A22 of this SA provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors.

A36. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the following:

- Discussion of fraud risks. However, the external auditors may make inquiries of internal auditors about fraud risks in the organization in accordance with SA 315²⁷.
- Determination of unannounced audit procedures as addressed in SA 240.

A37. Similarly, since in accordance with SA 505²⁸ the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

A38. The amount of judgment involved and the risk of material misstatement are also relevant in determining the work that may be assigned to internal auditors providing direct assistance. For example, in circumstances where the valuation of accounts receivable is assessed as an area of higher risk, the external auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

A39. Notwithstanding the direction, supervision and review by the external auditor, excessive use of internal auditors to provide direct assistance may affect perceptions regarding the independence of the external audit engagement.

²⁷ SA 315, paragraph 6(a).

²⁸ SA 505, External Confirmations, paragraphs 7 and 16.

Using Internal Auditors to Provide Direct Assistance (Ref: Para. 34)

A40. As individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, the external auditor's direction, supervision and review of the work performed by internal auditors providing direct assistance will generally be of a different nature and more extensive than if members of the engagement team perform the work.

A41. In directing the internal auditors, the external auditor may, for example, remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor. In reviewing the work performed by the internal auditors, the external auditor's considerations include whether the evidence obtained is sufficient and appropriate in the circumstances, and that it supports the conclusions reached.

RELATED CONFORMING AMENDMENTS

Note: The following are conforming amendments to SQC 1 and other SAs as a result of SA 610 (Revised), *Using the Work of Internal Auditors*. The footnote numbers within these amendments do not align with the SAs that will be amended, and reference should be made to those SAs.

SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

Definitions

6. In this SQC, the following terms have the meanings attributed below:

(e) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement. The term “engagement team” excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of SA 610 (Revised)²⁹.

SA 220, Quality Control for an Audit of Financial Statements

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

(d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement. The term “engagement team” excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of SA 610 (Revised)³⁰.

²⁹ SA 610 (Revised), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

³⁰ SA 610 (Revised), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

SA 260, Communication with Those Charged with Governance

A18. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner, and the nature and extent of any planned use of internal auditors to provide direct assistance³¹.
- SA 300, Planning an Audit of Financial Statements

Appendix

Characteristics of the Engagement

- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work, or internal auditors can be used to provide direct assistance.

SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

6. The risk assessment procedures shall include the following:

- (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6-A13)

23. If the entity has an internal audit function³², the auditor shall obtain an understanding of ~~the following in order to determine whether the internal audit function is likely to be relevant to the audit:~~

- ~~(a) The nature of the internal audit function's responsibilities, and how the internal audit function fits in the entity's organisational structure status, and~~
- ~~(b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A101-109 - A103-116)~~

Inquiries of Management, the Internal Audit Function and Others Within the Entity (Ref: Para. 6(a))

A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.

~~A7. However,~~ The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

³¹ SA 610 (Revised), paragraphs 20 and 31.

³² SA 610 (Revised), "Using the Work of Internal Auditors", paragraph 7(a)14(a), defines the term "internal audit function" for purposes of the SAs.

□

□ ~~Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.~~

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Inquiries of the Internal Audit Function

A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed³³. Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.

A11. In addition, in accordance with SA 240³⁴, if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.

A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities (Ref: Para 6(a))

A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

³³ The relevant requirements are contained in SA 610 (Revised).

³⁴ SA 240, paragraph 19.

I.444 Auditing Pronouncements

A79. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

The Entity's Internal Audit Functions-(Ref: Para 23)

A109404. ~~If the The entity's has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this SA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement. is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 applies.~~

A110102. The objectives and scope of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting. These matters may be set out in an internal audit charter or terms of reference.

A111. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focussed on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

A112. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this SA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

A113103. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a

direct reporting relationship to those charged with governance.the external auditor's consideration of the activities performed, or to be performed by, the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

A114. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, SA 610 (Revised) applies.

A115. As is further discussed in SA 610 (Revised), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A116. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. SA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

SA 620*

Using the Work of an Auditor's Expert
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
2. This SA does not deal with:
 - (a) Situations where the engagement team includes a member with expertise in specialised area of accounting or auditing, which is dealt with in SA 220¹; or
 - (b) The auditor's use of the work of an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (a management's expert), which is dealt with in SA 500².

The Auditor's Responsibility for the Audit Opinion

3. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this SA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

5. The objectives of the auditor are:
 - (a) To determine whether to use the work of an auditor's expert; and
 - (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Auditor's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a

* Published in March, 2010 issue of the Journal.

¹ SA 220, "Quality Control for an Audit of Financial Statements", paragraph A20.

² SA 500, "Audit Evidence", paragraphs A34-A48.

partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: Para. A1-A3)

- (b) Expertise – Skills, knowledge and experience in a particular field.
- (c) Management's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Requirements

Determining the Need for an Auditor's Expert

7. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: Para. A4-A9)

Nature, Timing and Extent of Audit Procedures

8. The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: Para. A10)

- (a) The nature of the matter to which that expert's work relates;
- (b) The risks of material misstatement in the matter to which that expert's work relates;
- (c) The significance of that expert's work in the context of the audit;
- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures. (Ref: Para. A11-A13)

The Competence, Capabilities and Objectivity of the Auditor's Expert

9. The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (Ref: Para. A14-A20)

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert

10. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to: (Ref: Para. A21-A22)

- (a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and
- (b) Evaluate the adequacy of that work for the auditor's purposes.

Agreement with the Auditor's Expert

11. The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert: (Ref: Para. A23-A26)

- (a) The nature, scope and objectives of that expert's work; (Ref: Para. A27)
- (b) The respective roles and responsibilities of the auditor and that expert; (Ref: Para. A28-A29)
- (c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and (Ref: Para. A30)
- (d) The need for the auditor's expert to observe confidentiality requirements. (Ref: Para. A31)

I.448 Auditing Pronouncements

Evaluating the Adequacy of the Auditor's Expert's Work

12. The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including: (Ref: Para. A32)

- (a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; (Ref: Para. A33-A34)
- (b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and (Ref: Para. A35-A37)
- (c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data. (Ref: Para. A38-A39)

13. If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall: (Ref: Para. A40)

- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (b) Perform further audit procedures appropriate to the circumstances.

Reference to the Auditor's Expert in the Auditor's Report

14. The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion. (Ref: Para. A41)

15. If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. (Ref: Para. A42)

Application and Other Explanatory Material

Definitions

Auditor's Expert (Ref: Para. 6(a))

A1. Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- The estimation of oil and gas reserves.
- The valuation of environmental liabilities, and site clean-up costs.
- The interpretation of contracts, laws and regulations.
- The analysis of complex or unusual tax compliance issues.

A2. In many cases, distinguishing between expertise in accounting or auditing, and expertise in another field, will be straightforward, even where this involves a specialised area of accounting or auditing. For example, an individual with expertise in applying methods of accounting for deferred income tax can often be easily distinguished from an expert in taxation law. The former is not an expert for the purposes of this SA as this constitutes accounting expertise; the latter is an expert for the purposes of this SA as this constitutes

legal expertise. Similar distinctions may also be able to be made in other areas, for example, between expertise in methods of accounting for financial instruments, and expertise in complex modeling for the purpose of valuing financial instruments. In some cases, however, particularly those involving an emerging area of accounting or auditing expertise, distinguishing between specialised areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment. Applicable professional rules and standards regarding education and competency requirements for accountants and auditors may assist the auditor in exercising that judgment.

A3. It is necessary to apply judgment when considering how the requirements of this SA are affected by the fact that an auditor's expert may be either an individual or an organisation. For example, when evaluating the competence, capabilities and objectivity of an auditor's expert, it may be that the expert is an organisation the auditor has previously used, but the auditor has no prior experience of the individual expert assigned by the organisation for the particular engagement; or it may be the reverse, that is, the auditor may be familiar with the work of an individual expert but not with the organisation that expert has joined. In either case, both the personal attributes of the individual and the managerial attributes of the organisation (such as systems of quality control the organisation implements) may be relevant to the auditor's evaluation.

Determining the Need for an Auditor's Expert (Ref: Para. 7)

A4. An auditor's expert may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, including its internal control.
- Identifying and assessing the risks of material misstatement.
- Determining and implementing overall responses to assessed risks at the financial statement level.
- Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.

A5. The risks of material misstatement may increase when expertise in a field other than accounting is needed for management to prepare the financial statements, for example, because this may indicate some complexity, or because management may not possess knowledge of the field of expertise. If in preparing the financial statements management does not possess the necessary expertise, a management's expert may be used in addressing those risks. Relevant controls, including controls that relate to the work of a management's expert, if any, may also reduce the risks of material misstatement.

A6. If the preparation of the financial statements involves the use of expertise in a field other than accounting, the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement³. Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement⁴. The auditor's determination of whether to use the work of an auditor's expert, and if so when and to what extent, assists the auditor in meeting these requirements. As the audit progresses, or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's expert.

A7. An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless

³ SA 220, paragraph 14.

⁴ SA 300, "Planning an Audit of Financial Statements", paragraph 7(e).

I.450 Auditing Pronouncements

be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through, for example:

- Experience in auditing entities that require such expertise in the preparation of their financial statements.
- Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter⁵.
- Discussion with auditors who have performed similar engagements.

A8. In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence. Considerations when deciding whether to use an auditor's expert may include:

- Whether management has used a management's expert in preparing the financial statements (see paragraph A9).
- The nature and significance of the matter, including its complexity.
- The risks of material misstatement in the matter.
- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the availability of alternative sources of audit evidence.

A9. When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

SA 500⁶ includes requirements and guidance regarding the effect of the competence, capabilities and objectivity of management's experts on the reliability of audit evidence.

Nature, Timing and Extent of Audit Procedures (Ref: Para. 8)

A10. The nature, timing and extent of audit procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. For example, the following factors may suggest the

⁵ SA 220, paragraph A21.

⁶ SA 500, paragraphs 8 and A34-A48.

need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

The Auditor's Firm's Quality Control Policies and Procedures (Ref: Para. 8(e))

A11. An auditor's internal expert may be a partner or staff, including temporary staff, of the auditor's firm, and therefore subject to the quality control policies and procedures of that firm in accordance with SQC 1⁷. Alternatively, an auditor's internal expert may be a partner or staff, including temporary staff, of a network firm, which may share common quality control policies and procedures with the auditor's firm.

A12. An auditor's external expert is not a member of the engagement team and is not subject to quality control policies and procedures in accordance with SQC 1⁸. Some law(s) or regulation(s), however, may require that an auditor's external expert be treated as a member of the engagement team, and may therefore be subject to relevant ethical and other professional requirements, including those relating to independence, as determined by such law(s) or regulation(s)⁹.

A13. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise¹⁰. The extent of that reliance will vary with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters as:

- Competence and capabilities, through recruitment and training programs.
- Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those pertaining to independence.
- The auditor's evaluation of the adequacy of the auditor's expert's work. For example, the firm's training programs may provide auditor's internal experts with an appropriate understanding of the interrelationship of their expertise with the audit process. Reliance on such training and other firm processes, such as protocols for scoping the work of auditor's internal experts, may affect the nature, timing and extent of the auditor's procedures to evaluate the adequacy of the auditor's expert's work.
- Adherence to regulatory and legal requirements, through monitoring processes.
- Agreement with the auditor's expert.

Such reliance does not reduce the auditor's responsibility to meet the requirements of this SA.

⁷ SQC 1, paragraph 6(e).

⁸ SQC 1, paragraph 6(e).

⁹ Relevant ethical requirements ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.

¹⁰ SA 220, paragraph 4.

I.452 Auditing Pronouncements

The Competence, Capabilities and Objectivity of the Auditor's Expert (Ref: Para. 9)

A14. The competence, capabilities and objectivity of an auditor's expert are factors that significantly affect whether the work of the auditor's expert will be adequate for the auditor's purposes. Competence relates to the nature and level of expertise of the auditor's expert. Capability relates to the ability of the auditor's expert to exercise that competence in the circumstances of the engagement. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the auditor's expert.

A15. Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- The auditor's firm's quality control policies and procedures (see paragraphs A11-A13)

A16. Matters relevant to evaluating the competence, capabilities and objectivity of the auditor's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A17. Other matters that may be relevant include:

- The relevance of the auditor's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialise in property and casualty insurance, but have limited expertise regarding pension calculations.
- The auditor's expert's competence with respect to relevant accounting and auditing requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the auditor's expert as the audit progresses.

A18. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats, and intimidation threats. Safeguards may eliminate or reduce such threats, and may be created by external structures (for example, the auditor's expert's profession, legislation or regulation), or by the auditor's expert's work environment (for example, quality control policies and procedures). There may also be safeguards specific to the audit engagement.

A19. The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit. There may be some circumstances in which safeguards cannot reduce threats to an acceptable level, for example, if a proposed auditor's expert is an individual who has played a significant role in

preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

A20. When evaluating the objectivity of an auditor's external expert, it may be relevant to:

- (a) Inquire of the entity about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.
- (b) Discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the auditor's expert include:
 - Financial interests.
 - Business and personal relationships.
 - Provision of other services by the expert, including by the organisation in the case of an external expert that is an organisation.
 - In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert (Ref: Para. 10)

A21. The auditor may obtain an understanding of the auditor's expert's field of expertise through the means described in paragraph A7, or through discussion with that expert.

A22. Aspects of the auditor's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit (see paragraph A17).
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods, including models where applicable, are used by the auditor's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the auditor's expert uses.

Agreement with the Auditor's Expert (Ref: Para. 11)

A23. The nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert regardless of whether the expert is an auditor's external expert or an auditor's internal expert.

A24. The matters noted in paragraph 8 may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:

- The auditor's expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.

I.454 Auditing Pronouncements

- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

A25. The agreement between the auditor and an auditor's external expert is often in the form of an engagement letter. The Appendix lists matters that the auditor may consider for inclusion in such an engagement letter, or in any other form of agreement with an auditor's external expert.

A26. When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example:

- Planning memoranda, or related working papers such as the audit program.
- The policies and procedures of the auditor's firm. In the case of an auditor's internal expert, the established policies and procedures to which that expert is subject may include particular policies and procedures in relation to that expert's work. The extent of documentation in the auditor's working papers depends on the nature of such policies and procedures. For example, no documentation may be required in the auditor's working papers if the auditor's firm has detailed protocols covering the circumstances in which the work of such an expert is used.

Nature, Scope and Objectives of Work (Ref: Para. 11(a))

A27. It may often be relevant when agreeing on the nature, scope and objectives of the auditor's expert's work to include discussion of any relevant technical performance standards or other professional or industry requirements that the expert will follow.

Respective Roles and Responsibilities (Ref: Para. 11(b))

A28. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may include:

- Whether the auditor or the auditor's expert will perform detailed testing of source data.
- Consent for the auditor to discuss the auditor's expert's findings or conclusions with the entity and others, and to include details of that expert's findings or conclusions in a modified auditor's report, if necessary (see paragraph A42).
- Any agreement to inform the auditor's expert of the auditor's conclusions concerning that expert's work.

Working Papers

A29. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may also include agreement about access to, and retention of, each other's working papers. When the auditor's expert is a member of the engagement team, that expert's working papers form part of the audit documentation. Subject to any agreement to the contrary, auditor's external experts' working papers are their own and do not form part of the audit documentation.

Communication (Ref: Para. 11(c))

A30. Effective two-way communication facilitates the proper integration of the nature, timing and extent of the auditor's expert's procedures with other work on the audit, and appropriate modification of the auditor's expert's objectives during the course of the audit. For example, when the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

Confidentiality (Ref: Para. 11(d))

A31. It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

Evaluating the Adequacy of the Auditor's Expert's Work (Ref: Para. 12)

A32. The auditor's evaluation of the auditor's expert's competence, capabilities and objectivity, the auditor's familiarity with the auditor's expert's field of expertise, and the nature of the work performed by the auditor's expert affect the nature, timing and extent of audit procedures to evaluate the adequacy of that expert's work for the auditor's purposes.

The Findings and Conclusions of the Auditor's Expert (Ref: Para. 12(a))

A33. Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
 - Observing the auditor's expert's work;
 - Examining published data, such as statistical reports from reputable, authoritative sources;
 - Confirming relevant matters with third parties;
 - Performing detailed analytical procedures; and
 - Re-performing calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

A34. Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are:

- Presented in a manner that is consistent with any standards of the auditor's expert's profession or industry;
- Clearly expressed, including reference to the objectives agreed with the auditor, the scope of the work performed and standards applied;
- Based on an appropriate period and take into account subsequent events, where relevant;
- Subject to any reservation, limitation or restriction on use, and if so, whether this has implications for the auditor; and
- Based on appropriate consideration of errors or deviations encountered by the auditor's expert.

Assumptions, Methods and Source Data

Assumptions and Methods (Ref: Para. 12(b))

A35. When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods. When the auditor's expert's work is to develop an auditor's point estimate or an

I.456 Auditing Pronouncements

auditor's range for comparison with management's point estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

A36. SA 540¹¹ discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

A37. When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialised models; and
- Consistent with those of management, and if not, the reason for, and effects of, the differences.

Source Data Used by the Auditor's Expert (Ref: Para. 12(c))

A38. When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and, where relevant, its transmission to the expert.
- Reviewing the data for completeness and internal consistency.

A39. In many cases, the auditor may test source data. However, in other cases, when the nature of the source data used by an auditor's expert is highly technical in relation to the expert's field, that expert may test the source data. If the auditor's expert has tested the source data, inquiry of that expert by the auditor, or supervision or review of that expert's tests may be an appropriate way for the auditor to evaluate that data's relevance, completeness, and accuracy.

Inadequate Work (Ref: Para. 13)

A40. If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures required by paragraph 13, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence¹².

Reference to the Auditor's Expert in the Auditor's Report (Ref: Para. 14-15)

A41. In some cases, law or regulation may require a reference to the work of an auditor's expert, for example, for the purposes of transparency in the public sector.

A42. It may be appropriate in some circumstances to refer to the auditor's expert in an auditor's report containing a modified opinion, to explain the nature of the modification. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

¹¹ SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", paragraphs 8, 13 and 15.

¹² SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 6(b).

Modifications vis-a-vis ISA 620, “Using the Work of an Auditor’s Expert”

SA 620, “Using the Work of an Auditor’s Expert” does not contain any modifications vis-à-vis ISA 620.

Appendix

(Ref: Para. A25)

Considerations for Agreement between the Auditor and an Auditor’s External Expert

This Appendix lists matters that the auditor may consider for inclusion in any agreement with an auditor’s external expert. The following list is illustrative and is not exhaustive; it is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. Whether to include particular matters in the agreement depends on the circumstances of the engagement. The list may also be of assistance in considering the matters to be included in an agreement with an auditor’s internal expert.

Nature, Scope and Objectives of the Auditor’s External Expert’s Work

- The nature and scope of the procedures to be performed by the auditor’s external expert.
- The objectives of the auditor’s external expert’s work in the context of materiality and risk considerations concerning the matter to which the auditor’s external expert’s work relates, and, when relevant, the applicable financial reporting framework.
- Any relevant technical performance standards or other professional or industry requirements the auditor’s external expert will follow.
- The assumptions and methods, including models where applicable, the auditor’s external expert will use, and their authority.
- The effective date of, or when applicable the testing period for, the subject matter of the auditor’s external expert’s work, and requirements regarding subsequent events.

The Respective Roles and Responsibilities of the Auditor and the Auditor’s External Expert

- Relevant auditing and accounting standards, and relevant regulatory or legal requirements.
- The auditor’s external expert’s consent to the auditor’s intended use of that expert’s report, including any reference to it, or disclosure of it, to others, for example reference to it in a modified auditor’s report, if necessary, or disclosure of it to management or an audit committee.
- The nature and extent of the auditor’s review of the auditor’s external expert’s work.
- Whether the auditor or the auditor’s external expert will test source data.
- The auditor’s external expert’s access to the entity’s records, files, personnel and to experts engaged by the entity.
- Procedures for communication between the auditor’s external expert and the entity.
- The auditor’s and the auditor’s external expert’s access to each other’s working papers.
- Ownership and control of working papers during and after the engagement, including any file retention requirements.
- The auditor’s external expert’s responsibility to perform work with due skill and care.
- The auditor’s external expert’s competence and capability to perform the work.

I.458 Auditing Pronouncements

- The expectation that the auditor's external expert will use all knowledge that expert has that is relevant to the audit or, if not, will inform the auditor.
- Any restriction on the auditor's external expert's association with the auditor's report.
- Any agreement to inform the auditor's external expert of the auditor's conclusions concerning that expert's work.

Communications and Reporting

- Methods and frequency of communications, including:
 - How the auditor's external expert's findings or conclusions will be reported (written report, oral report, ongoing input to the engagement team, etc.).
 - Identification of specific persons within the engagement team who will liaise with the auditor's external expert.
- When the auditor's external expert will complete the work and report findings or conclusions to the auditor.
- The auditor's external expert's responsibility to communicate promptly any potential delay in completing the work, and any potential reservation or limitation on that expert's findings or conclusions.
- The auditor's external expert's responsibility to communicate promptly instances in which the entity restricts that expert's access to records, files, personnel or experts engaged by the entity.
- The auditor's external expert's responsibility to communicate to the auditor all information that expert believes may be relevant to the audit, including any changes in circumstances previously communicated.
- The auditor's external expert's responsibility to communicate circumstances that may create threats to that expert's objectivity, and any relevant safeguards that may eliminate or reduce such threats to an acceptable level.

Confidentiality

- The need for the auditor's expert to observe confidentiality requirements, including:
 - The confidentiality provisions of relevant ethical requirements that apply to the auditor.
 - Additional requirements that may be imposed by law or regulation, if any.
 - Specific confidentiality provisions requested by the entity, if any.

SA 700 (Revised)

Forming an Opinion and Reporting on Financial Statements

(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.
2. SA 701¹ deals with the auditor's responsibility to communicate key audit matters in the auditor's report. SA 705² (Revised) and SA 706³ (Revised) deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report. Other SAs also contain reporting requirements that are applicable when issuing an auditor's report.
3. This SA applies to an audit of a complete set of general purpose financial statements and is written in that context. SA 800⁴ deals with special considerations when financial statements are prepared in accordance with a special purpose framework. SA 805⁵ deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement. This SA also applies to audits for which SA 800 or SA 805 apply.
4. The requirements of this SA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

¹ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

² SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

³ SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

⁴ SA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*.

⁵ SA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*.

Objectives

6. The objectives of the auditor are:
- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
 - (b) To express clearly that opinion through a written report.

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) General purpose financial statements – Financial statements prepared in accordance with a general purpose framework.
 - (b) General purpose framework – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.⁶

- (c) Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.⁷

8. Reference to “financial statements” in this SA means “a complete set of general purpose financial statements, including the related notes.” The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information and any other information required to be included as part of the financial statements by the laws and regulations governing the entity. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements.

9. Reference to “Accounting Standards” in this SA includes :

- The Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI)⁸; or
- The Standards of Accounting notified by the Central Government in pursuance of section 133 of the

⁶ SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraph 13(a).

⁷ Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

⁸ For example, the Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India.

Companies Act, 2013 and the Rules thereunder; or

- The International Financial Reporting Standards (IFRSs); or
- The International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board;

as may be applicable to the entity.

Requirements

Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.^{9&10}

11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- (a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained;¹¹
- (b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate;¹² and
- (c) The evaluations required by paragraphs 12–15.

12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1–A3)

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

- (a) The financial statements adequately disclose the significant accounting policies selected and applied;
- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4)
- (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

⁹ SA 200, paragraph 11

¹⁰ Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

¹¹ SA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26

¹² SA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

I.462 Auditing Pronouncements

14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of:

- (a) The overall presentation, structure and content of the financial statements; and
- (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A5–A10)

Form of Opinion

16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

17. If the auditor:

- (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

the auditor shall modify the opinion in the auditor's report in accordance with SA 705 (Revised).

18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705 (Revised). (Ref: Para. A11)

19. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report. (Ref: Para. A12)

Auditor's Report

20. The auditor's report shall be in writing. (Ref: Para. A13–A14)

Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

Title

21. The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor. (Ref: Para. A15)

Addressee

22. The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. (Ref: Para. A16)

Auditor's Opinion

23. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

24. The Opinion section of the auditor's report shall also:
- (a) Identify the entity whose financial statements have been audited;
 - (b) State that the financial statements have been audited;
 - (c) Identify the title of each statement comprising the financial statements;
 - (d) Refer to the notes, including the summary of significant accounting policies; and
 - (e) Specify the date of, or period covered by, each financial statement comprising the financial statements. (Ref: Para. A17–A18)
25. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:
- (a) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or
 - (b) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework]. (Ref: Para. A19–A26)
26. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A21–A26)
27. If the reference to the applicable financial reporting framework in the auditor's opinion is not to Accounting Standards referred to in paragraph 9, the auditor's opinion shall identify the origin of such other framework.

Basis for Opinion

28. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: (Ref: Para. A27)
- (a) States that the audit was conducted in accordance with Standards on Auditing; (Ref: Para. A28)
 - (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
 - (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the *Code of Ethics issued by ICAI* (Ref: Para. A29–A34)
 - (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going Concern

29. Where applicable, the auditor shall report in accordance with SA 570 (Revised).¹³

Key Audit Matters

30. For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.
31. When the auditor is otherwise required by law or regulation or decides to communicate key audit

¹³ SA 570 (Revised), *Going Concern*, paragraphs 21–23

I.464 Auditing Pronouncements

matters in the auditor's report, the auditor shall do so in accordance with SA 701. (Ref: Para. A35– A38)

Responsibilities for the Financial Statements

32. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance. (Ref: Para. A39)

33. This section of the auditor's report shall describe management's responsibility for: (Ref: Para. A40–A43)

- (a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (b) Assessing the entity's ability to continue as a going concern¹⁴ and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate. (Ref: Para. A43)

34. This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in paragraph 33 above. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to entity. (Ref: Para. A44)

35. When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

Auditor's Responsibilities for the Audit of the Financial Statements

36. The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

37. This section of the auditor's report shall: (Ref: Para. A45)

- (a) State that the objectives of the auditor are to:
 - (i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
 - (ii) Issue an auditor's report that includes the auditor's opinion. (Ref: Para. A46)
- (b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
- (c) State that misstatements can arise from fraud or error, and either:
 - (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or¹⁵
 - (ii) Provide a definition or description of materiality in accordance with the applicable financial

¹⁴ SA 570 (Revised), paragraph 2

¹⁵ SA 320, Materiality in Planning and Performing an Audit, paragraph 2

reporting framework. (Ref: Para. A47)

38. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further: (Ref: Para. A45)

- (a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
- (b) Describe an audit by stating that the auditor's responsibilities are:
 - (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
 - (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
 - (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
 - (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.
 - (v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- (c) When SA 600¹⁶ applies, further describe the auditor's responsibilities in a group audit engagement by stating:

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors

39. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall: (Ref: Para. A45)

¹⁶ SA 600, Using the Work of Another Auditor.

I.466 Auditing Pronouncements

- (a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- (b) State that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and
- (c) For audits of financial statements of all such entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. In accordance with the requirements of SA 701, the auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. (Ref: Para. A48)

Location of the description of the auditor's responsibilities for the audit of the financial statements

40. The description of the auditor's responsibilities for the audit of the financial statements required by paragraphs 38–39 shall be included: (Ref: Para. A49)

- (a) Within the body of the auditor's report;
- (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or (Ref: Para. A49–A50)
- (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or the auditing standards expressly permit the auditor to do so. (Ref: Para. A49, A51–A52)

41. When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements in paragraphs 38–39 of this SA. (Ref: Para. A51)

Other Reporting Responsibilities

42. If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs. (Ref: Para. A53–A55)

43. If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs. (Ref: Para. A55)

44. If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of paragraphs 20–39 of this SA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements." (Ref: Para. A55)

Signature of the Auditor

45. The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them¹⁷. (Ref: Para. A56-A57)

Place of Signature

46. The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

Date of the Auditor's Report

47. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A58–A61)

- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Auditor's Report Prescribed by Law or Regulation

48. If the auditor is required by law or regulation applicable to the entity to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements: (Ref: Para. A62– A63)

- (a) A title.
- (b) An addressee, as required by the circumstances of the engagement.
- (c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (see paragraph 27).
- (d) An identification of the entity's financial statements that have been audited.
- (e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.
- (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements in paragraph 22 of SA 570 (Revised).

¹⁷ The Council of the ICAI, at its 292nd meeting held in January 2010, decided to require the members of the ICAI to include, in addition to the other requirements relating to signature on the audit report, as prescribed under the relevant Standard on Auditing, the registration number of the firm as allotted by ICAI, in the audit reports signed by them, and ensure that the resolution passed by the company regarding appointment of the statutory auditor of the company under section 224 of the Companies Act, 1956, also contain the registration number of the firm of the auditor(s) with the ICAI. These requirements came into effect from April 1, 2010. Subsequently, the Council of the ICAI, at its 296th meeting held in June 2010, decided to extend the requirement to mention the firm registration number to all reports issued pursuant to any attestation engagement, including certificates, issued by the members as proprietor of/ partner in the said firm. The requirement applies where such firm registration number has been allotted by the ICAI. The Council further decided to make this requirement effective for all attestation reports/ certificates issued on or after 1st October, 2010.

I.468 Auditing Pronouncements

- (g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements in paragraph 23 of SA 570 (Revised).
- (h) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA.¹⁸ (Ref: Para. A63–A64)
- (i) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements in paragraphs 32–35.
- (j) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements in paragraphs 36–39. (Ref: Para. A49–A50)
- (k) The auditor's signature.
- (l) The Place of signature
- (m) The date of the auditor's report.

Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction

49. An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if: (Ref: Para. A68–A69)

- (a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and
- (b) The auditor's report includes, at a minimum, each of the elements set out in paragraphs 48(a)–(m) above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in paragraph 48(j) shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

50. When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

Supplementary Information Presented with the Financial Statements(Ref: Para. A70–A76)

51. If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.

52. If supplementary information that is not required by the applicable financial reporting framework is not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited

¹⁸ SA 701, paragraphs 11–16

financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.

Application and Other Explanatory Material

Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 12)

A1. Management makes a number of judgments about the amounts and disclosures in the financial statements.

A2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices¹⁹. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation of whether the financial statements as a whole are materially misstated include the following:

- The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
- Possible management bias in the making of accounting estimates.

A3. SA 540 addresses possible management bias in making accounting estimates.²⁰ Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Disclosures of the Effect of Material Transactions and Events on the Information Conveyed in the Financial Statements (Ref: Para. 13(e))

A4. It is common for financial statements prepared in accordance with a general purpose framework to present an entity's financial position, financial performance and cash flows. In such circumstances, the auditor evaluates whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows.

Description of the Applicable Financial Reporting Framework (Ref: Para. 15)

A5. As explained in SA 200, the preparation of the financial statements by management and, where appropriate, those charged with governance requires the inclusion of an adequate description of the applicable financial reporting framework in the financial statements.²¹ That description advises users of the financial statements of the framework on which the financial statements are based.

A6. A description that the financial statements are prepared in accordance with a particular applicable financial reporting framework is appropriate only if the financial statements comply with all the requirements of that framework that are effective during the period covered by the financial statements.

¹⁹ SA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

²⁰ SA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

²¹ SA 200, paragraphs A2–A3

I.470 Auditing Pronouncements

A7. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g., “the financial statements are in substantial compliance with Accounting Standards”) is not an adequate description of that framework as it may mislead users of the financial statements.

Reference to More than One Financial Reporting Framework

A8. In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (e.g., Accounting Standards referred to in section 133 of the Companies Act, 2013 and the IFRSs). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the other framework (e.g., IFRSs) has been adopted as the framework applicable to that entity, or has eliminated all barriers to compliance with it.

A9. Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary statement reconciling the results to those that would be shown under another framework are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.

A10. The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (e.g., financial statements prepared in accordance with the Accounting Standards that also describe the extent to which they comply with IFRSs). Such description may constitute supplementary financial information as discussed in paragraph 52 and is covered by the auditor’s opinion if it cannot be clearly differentiated from the financial statements.

Form of Opinion (Ref: Para. 18–19)

A11. There may be cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, it may be possible for management to include additional disclosures in the financial statements beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements.

A12. It will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with SA 210, the auditor determined that the framework is acceptable.²²

Auditor’s Report (Ref: Para. 20)

A13. A written report encompasses reports issued in hard copy and those using an electronic medium.

A14. The Appendix to this SA contains illustrations of auditor’s reports on financial statements, incorporating the elements set out in paragraphs 20–47. With the exception of the Opinion and Basis for Opinion sections, this SA does not establish requirements for ordering the elements of the auditor’s report. However, this SA requires the use of specific headings, which are intended to assist in making auditor’s reports that refer to audits that have been conducted in accordance with SAs more recognizable, particularly in situations where the elements of the auditor’s report are presented in an order that differs from the illustrative auditor’s reports in the Appendix to this SA.

Auditor’s Report for Audits Conducted in Accordance with Standards on Auditing

²² SA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

Title (Ref: Para. 21)

A15. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

Addressee (Ref: Para. 22)

A16. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed in that particular jurisdiction. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Auditor's Opinion (Ref. Para. 24–26)

Reference to the financial statements that have been audited

A17. The auditor's report states, for example, that the auditor has audited the financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and notes to the financial statements, including a summary of significant accounting policies.

A18. When the auditor is aware that the audited financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor's report relates.

"Present fairly, in all material respects" or "give a true and fair view"

A19. The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent. Whether the phrase "present fairly, in all material respects," or the phrase "give a true and fair view" is used in any particular jurisdiction is determined by the law or regulation governing the audit of financial statements in that jurisdiction, or by generally accepted practice in that jurisdiction. Where law or regulation requires the use of different wording, this does not affect the requirement in paragraph 14 of this SA for the auditor to evaluate the fair presentation of financial statements prepared in accordance with a fair presentation framework.

A20. When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

Description of the financial statements and the matters they present

A21. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements may include: Balance sheet, Profit and Loss Accounts, a statement of changes in equity, a statement of cash flows, and related notes, which ordinarily comprise a summary of significant accounting policies and other explanatory information. In some entities, additional information may also be considered to be an integral part of the financial statements.

A22. In the case of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion states that the financial statements present fairly, in all material respects, or give a true and fair view of, the matters that the financial statements are designed to present. For example, in the case of companies under the Companies Act, 2013, the financial statements for financial year 2014-15, prepared in accordance with the Companies (Accounting Standards) Rules, 2006, these matters are present *true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss or cash flow for*

I.472 Auditing Pronouncements

the year. Consequently, the [...] in paragraph 25 and elsewhere in this SA is intended to be replaced by the words in italics in the preceding sentence when the applicable financial reporting framework is Ind AS/ Accounting Standard or, in the case of other applicable financial reporting frameworks, be replaced with words that describe the matters that the financial statements are designed to present.

Description of the applicable financial reporting framework and how it may affect the auditor's opinion

A23. The identification of the applicable financial reporting framework in the auditor's opinion is intended to advise users of the auditor's report of the context in which the auditor's opinion is expressed; it is not intended to limit the evaluation required in paragraph 14. The applicable financial reporting framework is identified in such terms as:

"...In accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013"
or

"...In accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India"

"... in accordance with International Financial Reporting Standards"

A24. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in such terms as "...in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013". SA 210 deals with circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements.²³

A25. As indicated in paragraph A8, the financial statements may be prepared in accordance with two financial reporting frameworks, which are therefore both applicable financial reporting frameworks. Accordingly, each framework is considered separately when forming the auditor's opinion on the financial statements, and the auditor's opinion in accordance with paragraphs 25–27 refers to both frameworks as follows:

- (a) If the financial statements comply with each of the frameworks individually, two opinions are expressed: that is, that the financial statements are prepared in accordance with one of the applicable financial reporting frameworks (e.g., in case of a company incorporated in India, the Accounting Standards issued pursuant to section 133 of the Companies Act, 2013) and an opinion that the financial statements are prepared in accordance with the other applicable financial reporting framework (e.g., IFRSs). These opinions may be expressed separately or in a single sentence (e.g., the financial statements are presented fairly, in all material respects [...], in accordance with accounting principles generally accepted in India and with IFRSs).
- (b) If the financial statements comply with one of the frameworks but fail to comply with the other framework, an unmodified opinion can be given that the financial statements are prepared in accordance with the one framework (e.g., in case of a company incorporated in India, the Accounting Standards issued pursuant to section 133 of the Companies Act, 2013) but a modified opinion given with regard to the other framework (e.g., IFRSs) in accordance with SA 705 (Revised).

A26. As indicated in paragraph A10, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. Such supplementary information is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements (see paragraphs 51–52 and related application material in paragraphs A70–A76). Accordingly,

- (a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is

²³ SA 210, paragraph 18

expressed in accordance with SA 705 (Revised).

- (b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users' understanding of the financial statements, an Emphasis of Matter paragraph is added in accordance with SA 706 (Revised), drawing attention to the disclosure.

Basis for Opinion (Ref: Para. 28)

A27. The Basis for Opinion section provides important context about the auditor's opinion. Accordingly, this SA requires the Basis for Opinion section to directly follow the Opinion section in the auditor's report.

A28. The reference to the standards used conveys to the users of the auditor's report that the audit has been conducted in accordance with established standards.

Relevant ethical requirements

A29. The identification of the applicable relevant ethical requirements increases transparency about those requirements relating to the particular audit engagement. SA 200 explains that relevant ethical requirements ordinarily comprise of Code of Ethics issued by the Institute of Chartered Accountants of India²⁴. When the relevant ethical requirements include those of the Code of Ethics, the statement may also make reference to the Code of Ethics. If the Code of Ethics related to an audit of financial statements constitutes all of the ethical requirements relevant to the audit, the statement need not identify a jurisdiction of origin.

A30. Relevant ethical requirements may exist in several different sources, such as the ethical code(s) and additional rules and requirements within law and regulation. When the independence and other relevant ethical requirements are contained in a limited number of sources, the auditor may choose to name the relevant source(s) (e.g., the name of the code, rule or regulation applicable in the jurisdiction), or may refer to a term that is commonly understood and that appropriately summarizes those sources (e.g., independence requirements for audits of private entities in Jurisdiction X).

A31. Law or regulation, applicable auditing standards or the terms of an audit engagement may require the auditor to provide in the auditor's report more specific information about the sources of the relevant ethical requirements, including those pertaining to independence that applied to the audit of the financial statements.

A32. In determining the appropriate amount of information to include in the auditor's report when there are multiple sources of relevant ethical requirements relating to the audit of the financial statements, an important consideration is balancing transparency against the risk of obscuring other useful information in the auditor's report.

Considerations specific to group audits

A33. In group audits when there are multiple sources of relevant ethical requirements, including those pertaining to independence, the reference in the auditor's report to the relevant ethical requirements refers to those that are applicable to the principal auditor.

A34. The SAs do not establish specific independence or ethical requirements for auditors, including component auditors, and thus do not extend, or otherwise override, the independence requirements of the ICAI Code of Ethics to which the principal auditor is subject, nor do the SAs require that the component auditor in all cases to be subject to the same specific independence requirements that are applicable to the principal auditor.

Key Audit Matters (Ref: Para. 30)

A35. Law or regulation may require communication of key audit matters for audits of entities other than

²⁴ SA 200, paragraph A14

I.474 Auditing Pronouncements

listed entities, for example, entities characterized in such law or regulation as public interest entities.

A36. The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities.

A37. SA 210 requires the auditor to agree the terms of the audit engagement with management and those charged with governance, as appropriate, and explains that the roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance arrangements of the entity and relevant law or regulation²⁵. SA 210 also requires the audit engagement letter or other suitable form of written agreement to include reference to the expected form and content of any reports to be issued by the auditor.²⁶ When the auditor is not otherwise required to communicate key audit matters, SA 210²⁷ explains that it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

Considerations specific to public sector entities

A38. Public sector entities, even where not listed, may be significant due to size, complexity or public interest aspects. In such cases, an auditor of a public sector entity may be required by law or regulation or may otherwise decide to communicate key audit matters in the auditor's report.

Responsibilities for the Financial Statements (Ref: Para. 32–33)

A39. SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted.²⁸ Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. SA 260 (Revised) uses the term those charged with governance to describe the person(s) or organization(s) with responsibility for overseeing the entity, and provides a discussion about the diversity of governance structures across jurisdictions and by entity.

A40. There may be circumstances when it is appropriate for the auditor to add to the descriptions of the responsibilities of management and those charged with governance in paragraphs 33–34 to reflect additional responsibilities that are relevant to the preparation of the financial statements in the context of the particular jurisdiction or the nature of the entity.

A41. SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other

²⁵ SA 210, paragraphs 9 and A 20

²⁶ SA 210, paragraph 10

²⁷ SA 210, paragraph A23a

²⁸ SA 200, paragraph 13(j)

suitable form of written agreement.²⁹ SA 210 provides some flexibility in doing so, by explaining that, if law or regulation prescribes the responsibilities of management and, where appropriate, those charged with governance in relation to financial reporting, the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in SA 210. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the engagement letter or other suitable form of written agreement. In such cases, this wording may also be used in the auditor's report to describe the responsibilities as required by paragraph 33(a) of this SA. In other circumstances, including where the auditor decides not to use the wording of law or regulation as incorporated in the engagement letter, the wording in paragraph 33(a) of this SA is used. In addition to including the description of management's responsibilities in the auditor's report as required by paragraph 33, the auditor may refer to a more detailed description of these responsibilities by including a reference to where such information may be obtained (e.g., in the annual report of the entity or a website of an appropriate authority).

A42. In some entities, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in SA 315³⁰), the descriptions in SA 210 and in paragraph 33 do not make specific reference to them.

A43. The Appendix to this SA provides illustrations of how the requirement in paragraph 33(b) would be applied when Accounting Standards is the applicable financial reporting framework. If an applicable financial reporting framework other than Accounting Standards is used, the illustrative statements featured in the Appendix to this SA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

Oversight of the financial reporting process (Ref: Para. 34)

A44. When some, but not all, of the individuals involved in the oversight of the financial reporting process are also involved in preparing the financial statements, the description as required by paragraph 34 of this SA may need to be modified to appropriately reflect the particular circumstances of the entity. When individuals responsible for the oversight of the financial reporting process are the same as those responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Auditor's Responsibilities for the Audit of the Financial Statements (Ref: Para. 36–39)

A45. The description of the auditor's responsibilities as required by paragraphs 36–39 of this SA may be tailored to reflect the specific nature of the entity, for example, when the auditor's report addresses consolidated financial statements. Illustration 2 in the Appendix to this SA includes an example of how this may be done.

Objectives of the auditor (Ref: Para. 37(a))

A46. The auditor's report explains that the objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes the auditor's opinion. These are in contrast to management's responsibilities for the preparation for the financial statements.

Description of materiality (Ref: Para. 37(c))

A47. The Appendix to this SA provides illustrations of how the requirement in paragraph 37(c), to provide a

²⁹ SA 210, paragraph 6(b)(i)–(ii)

³⁰ SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, paragraph 4(c)

I.476 Auditing Pronouncements

description of materiality, would be applied when Accounting Standards is the applicable financial reporting framework. If an applicable financial reporting framework other than Accounting Standards is used, the illustrative statements presented in the Appendix to this SA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

Auditor's responsibilities relating to SA 701 (Ref: Para. 39(c))

A48. The auditor may also consider it useful to provide additional information in the description of the auditor's responsibilities beyond what is required by paragraph 39(c). For example, the auditor may make reference to the requirement in paragraph 9 of SA 701 to determine the matters that required significant auditor attention in performing the audit, taking into account areas of higher assessed risk of material misstatement or significant risks identified in accordance with SA 315 ; significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and the effects on the audit of significant events or transactions that occurred during the period.

Location of the description of the auditor's responsibilities for the audit of the financial statements (Ref: Para. 40, 48(j))

A49. Including the information required by paragraphs 38–39 of this SA in an appendix to the auditor's report or, when law, regulation or national auditing standards expressly permit, referring to a website of an appropriate authority containing such information may be a useful way of streamlining the content of the auditor's report. However, because the description of the auditor's responsibilities contains information that is necessary to inform users' expectations of an audit conducted in accordance with SAs, a reference is required to be included in the auditor's report indicating where such information can be accessed.

Location in an appendix (Ref: Para. 40(b), 48(j))

A50. Paragraph 40 permits the auditor to include the statements required by paragraphs 38–39 describing the auditor's responsibilities for the audit of the financial statements in an appendix to the auditor's report, provided that appropriate reference is made within the body of the auditor's report to the location of the appendix. The following is an illustration of how such a reference to an appendix could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [*indicate page number or other specific reference to the location of the description*], forms part of our auditor's report.

Reference to a website of an appropriate authority (Ref: Para. 40(c), 41)

A51. Paragraph 40 explains that the auditor may refer to a description of the auditor's responsibilities located on a website of an appropriate authority, only if expressly permitted by law, regulation or the applicable auditing standards. The information on the website that is incorporated in the auditor's report by way of a specific reference to the website location where such information can be found may describe the auditor's work, or the audit in accordance with SAs more broadly, but it cannot be inconsistent with the

description required in paragraphs 38–39 of this SA. This means that the wording of the description of the auditor’s responsibilities on the website may be more detailed, or may address other matters relating to an audit of financial statements, provided that such wording reflects and does not contradict the matters addressed in paragraphs 38–39.

A52. An appropriate authority could be a national auditing standard setter, regulator, or an audit oversight body. Such organizations are well-placed to ensure the accuracy, completeness and continued availability of the standardized information. It would not be appropriate for the auditor to maintain such a website. The following is an illustration of how such a reference to a website could be made in the auditor’s report:

Auditor’s Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located at [Organization’s] website at: [website address]. This description forms part of our auditor’s report.

Other Reporting Responsibilities (Ref: Para. 42–44)

A53. In case of some entities, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor’s responsibilities under the SAs. For example, the auditor may be asked to report certain matters if they come to the auditor’s attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records, internal control over financial reporting or other information. Standards on Auditing and/or other relevant pronouncements of the ICAI often provide guidance on the auditor’s responsibilities with respect to specific additional reporting responsibilities.

A54. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities as part of their auditor’s report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.

A55. Paragraphs 42–44 of this SA permit combined presentation of other reporting responsibilities and the auditor’s responsibilities under the SAs only when they address the same topics and the wording of the auditor’s report clearly differentiates the other reporting responsibilities from those under the SAs. Such clear differentiation may make it necessary for the auditor’s report to refer to the source of the other reporting responsibilities and to state that such responsibilities are beyond those required under the SAs. Otherwise, other reporting responsibilities are required to be addressed in a separate section in the auditor’s report with a heading “Report on Other Legal and Regulatory Requirements,” or otherwise as appropriate to the content of the section. In such cases, paragraph 44 requires the auditor to include reporting responsibilities under the SAs under a heading titled “Report on the Audit of the Financial Statements.”

Signature of the Auditor (Ref: Para 45)

A56. SQC 1³¹ requires that the firm establish policies and procedures to provide reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory

³¹ SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, paragraph 3

I.478 Auditing Pronouncements

requirements. Notwithstanding these SQC 1 requirements, naming the engagement partner in the auditor's report is intended to provide further transparency to the users of the auditor's report of a complete set of general purpose financial statements of an entity.

A57. In some cases, law or regulation may allow for the use of electronic signatures in the auditor's report.

Date of the Auditor's Report (Ref: Para. 47)

A58. The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560.³²

A59. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements that comprise the financial statements, including the related notes, have been prepared and management has accepted responsibility for them.

A60. In the case of some entities, the applicable law or regulation identifies the individuals or bodies (e.g., the directors) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In case of some entities, however, the approval process may not be prescribed in the applicable law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation identifies the point in the financial statement reporting process at which the audit is expected to be complete.

A61. In the case of some entities, the Final approval of the financial statements by shareholders is required before the financial statements are issued publicly. Final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of SAs is the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

Auditor's Report Prescribed by Law or Regulation (Ref: Para 48)

A62. SA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to SAs.³³ When the differences between the legal or regulatory requirements and SAs relate only to the layout and wording of the auditor's report, the requirements in paragraph 48(a)–(m) set out the minimum elements to be included in the auditor's report to enable a reference to the Standards on Auditing. In those circumstances, the requirements in paragraphs 21–47 that are not included in paragraph 48(a)–(n) do not need to be applied including, for example, the required ordering of the Opinion and Basis for Opinion sections.

A63. Where specific requirements in a particular law or regulation do not conflict with SAs, the layout and wording required by paragraphs 21–47 of this SA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with SAs.

Information Required by SA 701 (Ref: Para. 48(h))

³² SA 560, *Subsequent Events*, paragraphs 10–17

³³ SA 200, paragraph A55

A64. Law or regulation may require the auditor to provide additional information about the audit that was performed, which may include information that is consistent with the objectives of SA 701, or may prescribe the nature and extent of communication about such matters.

A65. The SAs do not override law or regulation that governs an audit of financial statements. When SA 701 is applicable, reference can only be made to SAs in the auditor's report if, in applying the law or regulation, the section required by paragraph 48(h) of this SA is not inconsistent with the reporting requirements in SA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by SA 701, for example by:

- Modifying the heading "Key Audit Matters", if law or regulation prescribes a specific heading;
- Explaining why the information required by law or regulation is being provided in the auditor's report, for example by making a reference to the relevant law or regulation and describing how that information relates to the key audit matters;
- Where law or regulation prescribes the nature and extent of the description, supplementing the prescribed information to achieve an overall description of each key audit matter that is consistent with the requirement in paragraph 13 of SA 701.

A66. SA 210 deals with circumstances where law or regulation applicable to the entity prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of SAs, which in particular includes the auditor's opinion. In these circumstances, SA 210 requires the auditor to evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, SA 210 requires the auditor not to accept the audit engagement, unless required by law or regulation to do so. In accordance with SA 210, an audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor does not include any reference in the auditor's report to the audit having been conducted in accordance with Standards on Auditing.³⁴

Considerations specific to public sector entities

A67. Auditors of public sector entities may also have the ability pursuant to law or regulation to report publicly on certain matters, either in the auditor's report or in a supplementary report, which may include information that is consistent with the objectives of SA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by SA 701 or include a reference in the auditor's report to a description of the matter in the supplementary report.

Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing issued by ICAI and International Standards on Auditing/ Auditing Standards of Another Jurisdiction (Ref: Para. 49)

A68. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both the Standards on Auditing issued by ICAI as well as the International Standards on Auditing/auditing standards of another jurisdiction when, in addition to complying with the ISAs/ auditing standards of such other jurisdiction, the auditor complies with each of the SAs relevant to the audit.

A69. A reference to both Standards on Auditing issued by ICAI and the International Standards on Auditing/auditing standards of another jurisdiction is not appropriate if there is a conflict between the requirements in SAs and those ISAs/ auditing standards of such other jurisdiction that would lead the auditor

³⁴ SA 210, paragraph 21

I.480 Auditing Pronouncements

to form a different opinion or not to include an Emphasis of Matter or Other Matter paragraph that, in the particular circumstances, is required by SAs. In such a case, the auditor's report refers only to the auditing standards (either Standards on Auditing issued by ICAI or ISAs/the auditing standards of such other jurisdiction) in accordance with which the auditor's report has been prepared.

Supplementary Information Presented with the Financial Statements (Ref: Para. 51-52)

A70. In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the applicable financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the applicable financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes.

A71. Paragraph 51 of this SA explains that the auditor's opinion covers supplementary information that is an integral part of the financial statements because of its nature or how it is presented. This evaluation is a matter of professional judgment. To illustrate:

- When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.
- When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an Appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

A72. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the auditor's report is sufficient.

A73. Law or regulation may not require that the supplementary information be audited, and management may decide to ask the auditor not to include the supplementary information within the scope of the audit of the financial statements.

A74. The auditor's evaluation whether unaudited supplementary information is presented in a manner that could be construed as being covered by the auditor's opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as "unaudited."

A75. Management could change the presentation of unaudited supplementary information that could be construed as being covered by the auditor's opinion, for example, by:

- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.
- Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labeling them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.

A76. The fact that supplementary information is unaudited does not relieve the auditor of the responsibilities described in Proposed SA 720 (Revised).³⁵

³⁵ Proposed SA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

Appendix
(Ref: Para. A14)

Illustrations of Independent Auditor's Reports on Financial Statements

- Illustration 1: An auditor's report on financial statements of a listed entity prepared in accordance with a fair presentation framework
- Illustration 2: An auditor's report on consolidated financial statements of a listed company prepared in accordance with a fair presentation framework
- Illustration 3 – Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework
- Illustration 4 – Auditor's Report on Financial Statements of a Non Corporate Entity Prepared in Accordance with a Fair Presentation Framework
- Illustration 5 – Auditor's Report on Financial Statements of Non Corporate Entity Prepared in Accordance with a General Purpose Compliance Framework

Illustration 1 – Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)² and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)]³.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)⁴ and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the *Code of Ethics* issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (*changes in equity*)⁵ and cash flows of the

¹ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

² Where applicable.

³ Where applicable.

⁴ Where applicable

⁵ Where applicable.

Company in accordance with⁶ the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

⁶ Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

I.484 Auditing Pronouncements

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matter

We did not audit the financial statements/ information of (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of Rs. as at 31st March 20XX and the total revenue of Rs. for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2016 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

- (b) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [*and proper returns adequate for the purposes of our audit have been received from the branches not visited by us.*⁷]
- (c) [*The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report*⁸.]
- (d) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [*and with the returns received from the branches not visited by us*⁹].
- (e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.
- (f) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (g) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".
- (h) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
 - i. The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; [*or the Company does not have any pending litigations which would impact its financial position*¹⁰]
 - ii. The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; [*or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.*¹¹]
 - iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {*or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund*

⁷ Where applicable.

⁸ Where applicable.

⁹ Where applicable.

¹⁰ As may be applicable.

¹¹ As may be applicable.

I.486 Auditing Pronouncements

by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company¹².

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation¹³)
(Membership No.
XXXXX)

Place of Signature:

Date:

Illustration 2 – Auditor's Report on Consolidated Financial Statements of a Listed Company (incorporated under the Companies Act, 2013) Prepared in Accordance with a Fair Presentation Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of a listed Company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The Code of Ethics issued by ICAI comprises all of the relevant ethical requirements that apply to the principal auditor in relation to this audit.
- Based on the audit evidence obtained, the principal auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the principal auditor has other reporting responsibilities required under the Companies Act, 2013.

¹² As may be applicable.

¹³ Partner or Proprietor, as the case may be

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Consolidated Financial Statements¹⁴

Opinion

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the 'Holding Company') and its subsidiaries (Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated statement of Profit and Loss, (*the consolidated statement of changes in equity*)¹⁵ and the consolidated cash flows Statement for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as "the consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid consolidated financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Company as at March 31, 20XX, of consolidated profit/loss, (*consolidated changes in equity*)¹⁶ and its consolidated cash flows for the year then ended.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the *Code of Ethics issued by ICAI*, and we have fulfilled our other ethical responsibilities in accordance with the provisions of the Companies Act, 2013. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

The Holding Company's Board of Directors is responsible for the preparation and presentation of these consolidated financial statements in term of the requirements of the Companies Act, 2013 that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Group including its Associates and Jointly controlled entities in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under section 133 of the Act. The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities are responsible for maintenance of adequate accounting records in

¹⁴ The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁵ Where applicable.

¹⁶ Where applicable.

I.488 Auditing Pronouncements

accordance with the provisions of the Act for safeguarding the assets of the Group and for preventing and detecting frauds and other irregularities; the selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and the design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error, which have been used for the purpose of preparation of the consolidated financial statements by the Directors of the Holding Company, as aforesaid.

In preparing the consolidated financial statements, the respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities are responsible for assessing the ability of the Group and of its associates and jointly controlled entities to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities are responsible for overseeing the financial reporting process of the Group and of its associates and jointly controlled entities.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or the applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the ability of the Group and its associates and jointly controlled entities to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group and its associates and jointly controlled entities to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group and its associates and jointly controlled entities to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the audit of the financial statements of such entities included in the consolidated financial statements of which we are the independent auditors. For the other entities included in the consolidated financial statements, which have been audited by other auditors, such other auditors remain responsible for the direction, supervision and performance of the audits carried out by them. We remain solely responsible for our audit opinion.

We communicate with those charged with governance of the Holding Company and such other entities included in the consolidated financial statements of which we are the independent auditors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matters

- (a) We did not audit the financial statements / financial information of _____ subsidiaries, and _____ jointly controlled entities, whose financial statements / financial information reflect total assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash flows amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of _____ associates, whose financial statements / financial information have not been audited by us. These financial statements / financial information have been audited by other auditors whose reports have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities and associates, and our report in terms of sub-sections (3) and (11) of Section 143 of

the Act, in so far as it relates to the aforesaid subsidiaries, jointly controlled entities and associates, is based solely on the reports of the other auditors.

- (b) We did not audit the financial statements / financial information of _____ subsidiaries and _____ jointly controlled entities, whose financial statements / financial information reflect total assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash flows amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of _____ associates, whose financial statements / financial information have not been audited by us. These financial statements / financial information are unaudited and have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities and associates, and our report in terms of sub-sections (3) and (11) of Section 143 of the Act in so far as it relates to the aforesaid subsidiaries, jointly controlled entities and associates, is based solely on such unaudited financial statements / financial information. In our opinion and according to the information and explanations given to us by the Management, these financial statements / financial information are not material to the Group.

Our opinion on the consolidated financial statements, and our report on Other Legal and Regulatory Requirements below, is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors and the financial statements / financial information certified by the Management.

Report on Other Legal and Regulatory Requirements

As required by Section 143(3) of the Act, we report, to the extent applicable, that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit of the aforesaid consolidated financial statements.
- (b) In our opinion, proper books of account as required by law relating to preparation of the aforesaid consolidated financial statements have been kept so far as it appears from our examination of those books and the reports of the other auditors.
- (c) The Consolidated Balance Sheet, the Consolidated Statement of Profit and Loss, and the Consolidated Cash Flow Statement dealt with by this Report are in agreement with the relevant books of account maintained for the purpose of preparation of the consolidated financial statements.
- (d) In our opinion, the aforesaid consolidated financial statements comply with the Accounting Standards specified under Section 133 of the Act.
- (e) On the basis of the written representations received from the directors of the Holding Company as on 31st March, 20XX taken on record by the Board of Directors of the Holding Company and the reports of the statutory auditors of its subsidiary companies, associate companies and jointly controlled companies incorporated in India, none of the directors of the Group companies, its associate companies and jointly controlled companies incorporated in India is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (f) With respect to the adequacy of internal financial controls over financial reporting of the Group and the operating effectiveness of such controls, refer to our separate report in Annexure.

(g) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditor's) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

i. The consolidated financial statements disclose the impact of pending litigations on the consolidated financial position of the Group, its associates and jointly controlled entities– Refer Note XX to the consolidated financial statements.

Or

There were no pending litigations which would impact the consolidated financial position of the Group, its associates and jointly controlled entities.¹⁷

ii. Provision has been made in the consolidated financial statements, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer (a) Note XX to the consolidated financial statements in respect of such items as it relates to the Group, its associates and jointly controlled entities and (b) the Group's share of net profit/loss in respect of its associates.

Or

The Group, its associates and jointly controlled entities did not have any material foreseeable losses on long-term contracts including derivative contracts.¹⁸

iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled companies incorporated in India.

Or

Following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Holding Company, and its subsidiary companies, associate companies and jointly controlled companies incorporated in India¹⁹.

Or

There were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Holding Company, and its subsidiary companies, associate companies and jointly controlled companies incorporated in India²⁰.

Place of Signature:

For XYZ & Co

Date:

Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation²¹)

(Membership No. XXXX)

¹⁷ Where applicable.

¹⁸ Where applicable.

¹⁹ Where applicable.

²⁰ Where applicable.

²¹ Partner or Proprietor

Illustration 3 – Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an unlisted company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements²²

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)²³ and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)]²⁴.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of

²² The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²³ Where applicable.

²⁴ Where applicable.

affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)²⁵ and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the *Code of Ethics* issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibility of Management for Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (*changes in equity*)²⁶ and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or the applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided

²⁵ Where applicable

²⁶ Where applicable.

I.494 Auditing Pronouncements

that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

Other Matter

We did not audit the financial statements/ information of (number) branches included in the standalone financial statements of the company whose financial statements/financial information reflect total assets of Rs.as at 31st March 20XX and the total revenue of Rs.for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2016 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

- (a) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [*and proper returns adequate for the purposes of our audit have been received from the branches not visited by us.*²⁷]
- (b) [*The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report*²⁸.]
- (c) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [*and with the returns received from the branches not visited by us*²⁹].
- (d) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.
- (e) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (f) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".
- (g) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
 - i. The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; [*or the Company does not have any pending litigations which would impact its financial position*³⁰]
 - ii. The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; [*or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.*³¹]
 - iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in

²⁷ Where applicable.

²⁸ Where applicable.

²⁹ Where applicable.

³⁰ As may be applicable.

³¹ As may be applicable.

I.496 Auditing Pronouncements

transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company³²).

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation³³)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 4 – Auditor's Report on Financial Statements of a Non Corporate Entity Prepared in Accordance with a Fair Presentation Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a non corporate entity using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are the Code of Ethics issued by ICAI³⁴.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law.
- The auditor elects to refer to the description of the auditor's responsibility included on a website of an appropriate authority.

³² As may be applicable.

³³ Partner or Proprietor, as the case may be

³⁴ Specify any applicable ethical requirements under the relevant laws or regulations applicable to the entity.

INDEPENDENT AUDITOR'S REPORT

To the Partners of ABC & Associates [or Other Appropriate Addressee]

Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet at March 31st 20XX, and the profit and loss account, *(and statement of cash flows)*³⁵ for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the entity as at March 31, 20XX, and of its financial performance *(and its cash flows)*³⁶ for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI).

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) issued by ICAI. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements³⁷

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the aforesaid Accounting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial

³⁵ Where applicable.

³⁶ Where applicable

³⁷ Or other terms that are appropriate in the context of the legal framework of the particular entity.

I.498 Auditing Pronouncements

statements.

A further description of the auditor's responsibilities for the audit of the financial statements is located at [Organization's] website at: [website link]. This description forms part of our auditor's report.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation³⁸)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 5 – Auditor's Report on Financial Statements of Non Corporate Entity Prepared in Accordance with a General Purpose Compliance Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity, other than a listed company under the Companies Act 2013, required by law or regulation. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Financial Reporting Framework (XYZ Laws) of Jurisdiction X (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law.

³⁸ Partner or Proprietor, as the case may be

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet as at March 31, 20X1, and the Profit and Loss Account (*and the cash flow statement*)³⁹ for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements of the entity are prepared, in all material respects, in accordance with XYZ Laws.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements, and we have fulfilled our other responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements⁴⁰

Management is responsible for the preparation of the financial statements in accordance with XYZ Law and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional

³⁹ Where applicable.

⁴⁰ Or other terms that are appropriate in the context of the legal framework of the particular entity.

I.500 Auditing Pronouncements

skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.⁴¹

Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the entity to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation⁴²)
(Membership No. XXXXX)

Place of Signature:

Date:

⁴¹ This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

⁴² Partner or Proprietor, as the case may be

SA 701

**Communicating Key Audit Matters in the
Independent Auditor's Report**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2017)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.
2. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements. (Ref: Para. A1–A4)
3. The communication of key audit matters in the auditor's report may also provide intended users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.
4. Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:
 - (a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
 - (b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);¹
 - (c) A substitute for reporting in accordance with SA 570 (Revised)² when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
 - (d) A separate opinion on individual matters. (Ref: Para. A5–A8)
5. This SA applies to audits of complete sets of general purpose financial statements of listed entities and circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report. This SA also applies when the auditor is required by law or regulation to communicate key audit matters in

¹ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

² SA 570 (Revised), *Going Concern*, paragraphs 22–23.

I.502 Auditing Pronouncements

the auditor's report.³ However, SA 705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation.⁴

Effective Date

6. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

7. The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

Definition

8. For purposes of the SAs, the following term has the meaning attributed below:

Key audit matters— Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

Requirements

Determining Key Audit Matters

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)

- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.⁵ (Ref: Para. A19–A22)
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23–A24)
- (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

10. The auditor shall determine which of the matters determined in accordance with paragraph 9 were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters. (Ref: Para. A9–A11, A27–A30)

Communicating Key Audit Matters

11. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters," unless the circumstances in paragraphs 14 or 15 apply. The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters. (Ref: Para. A31–A33)

³ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 30–31.

⁴ SA 705 (Revised), paragraph 29.

⁵ SA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

Key Audit Matters Not a Substitute for Expressing a Modified Opinion

12. The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter. (Ref: Para. A5)

Descriptions of Individual Key Audit Matters

13. The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address: (Ref: Para. A34–A41)

- (a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and (Ref: Para. A42–A45)
- (b) How the matter was addressed in the audit. (Ref: Para. A46–A51)

Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report

14. The auditor shall describe each key audit matter in the auditor's report unless: (Ref: Para. A53– A56)

- (a) Law or regulation precludes public disclosure about the matter; or (Ref: Para. A52)
- (b) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

Interaction between Descriptions of Key Audit Matters and Other Elements Required to Be Included in the Auditor's Report

15. A matter giving rise to a modified opinion in accordance with SA 705 (Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised), are by their nature key audit matters. However, in such circumstances, these matters shall not be described in the Key Audit Matters section of the auditor's report and the requirements in paragraphs 13–14 do not apply. Rather, the auditor shall:

- (a) Report on these matter(s) in accordance with the applicable SA(s); and
- (b) Include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section. (Ref: Para. A6–A7)

Form and Content of the Key Audit Matters Section in Other Circumstances

16. If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate or that the only key audit matters communicated are those matters addressed by paragraph 15, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters." (Ref: Para. A57– A59)

Communication with Those Charged with Governance

17. The auditor shall communicate with those charged with governance:

- (a) Those matters the auditor has determined to be the key audit matters; or
- (b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report. (Ref: Para. A60–A63)

I.504 Auditing Pronouncements

Documentation

18. The auditor shall include in the audit documentation:⁶ (Ref: Para. A64)
- (a) The matters that required significant auditor attention as determined in accordance with paragraph 9, and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter in accordance with paragraph 10;
 - (b) Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report or that the only key audit matters to communicate are those matters addressed by paragraph 15; and
 - (c) Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter.

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 2)

A1. Significance can be described as the relative importance of a matter, taken in context. The significance of a matter is judged by the auditor in the context in which it is being considered. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients. This involves an objective analysis of the facts and circumstances, including the nature and extent of communication with those charged with governance.

A2. Users of financial statements have expressed an interest in those matters about which the auditor had the most robust dialogue with those charged with governance as part of the two-way communication required by SA 260 (Revised)⁷ and have called for additional transparency about those communications. For example, users have expressed particular interest in understanding significant judgments made by the auditor in forming the opinion on the financial statements as a whole, because they are often related to the areas of significant management judgment in preparing the financial statements.

A3. Requiring auditors to communicate key audit matters in the auditor's report may also enhance communications between the auditor and those charged with governance about those matters, and may increase attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report.

A4. SA 320⁸ explains that it is reasonable for the auditor to assume that users of the financial statements:

- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- (b) Understand that the financial statements are prepared, presented and audited to levels of materiality;
- (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- (d) Make reasonable economic decisions on the basis of the information in the financial statements.

Because the auditor's report accompanies the audited financial statements, the users of the auditor's report are considered to be the same as the intended users of the financial statements.

Relationship between Key Audit Matters, the Auditor's Opinion and Other Elements of the Auditor's Report

⁶ SA 230, *Audit Documentation*, paragraphs 8–11 and A6.

⁷ SA 260 (Revised), *Communication with Those Charged with Governance*.

⁸ SA 320, *Materiality in Planning and Performing the Audit*, paragraph 4.

(Ref: Para. 4, 12, 15)

A5. SA 700 (Revised) establishes requirements and provides guidance on forming an opinion on the financial statements.⁹ Communicating key audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation. SA 705 (Revised) addresses circumstances in which the auditor concludes that there is a material misstatement relating to the appropriateness or adequacy of disclosures in the financial statements.¹⁰

A6. When the auditor expresses a qualified or adverse opinion in accordance with SA 705 (Revised), presenting the description of a matter giving rise to a modified opinion in the Basis for Qualified (Adverse) Opinion section helps to promote intended users' understanding and to identify such circumstances when they occur. Separating the communication of this matter from other key audit matters described in the Key Audit Matters section, therefore, gives it the appropriate prominence in the auditor's report (see paragraph 15). The Appendix in SA 705 (Revised) includes illustrative examples of how the introductory language in the Key Audit Matters section is affected when the auditor expresses a qualified or adverse opinion and other key audit matters are communicated in the auditor's report. Paragraph A58 of this SA illustrates how the Key Audit Matters section is presented when the auditor has determined that there are no other key audit matters to be communicated in the auditor's report beyond matters addressed in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section of the auditor's report.

A7. When the auditor expresses a qualified or adverse opinion, communicating other key audit matters would still be relevant to enhancing intended users' understanding of the audit, and therefore the requirements to determine key audit matters apply. However, as an adverse opinion is expressed in circumstances when the auditor has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements:¹¹

- Depending on the significance of the matter(s) giving rise to an adverse opinion, the auditor may determine that no other matters are key audit matters. In such circumstances, the requirement in paragraph 15 applies (see paragraph A58).
- If one or more matters other than the matter(s) giving rise to an adverse opinion are determined to be key audit matters, it is particularly important that the descriptions of such other key audit matters do not imply that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, in view of the adverse opinion (see paragraph A47).

A8. SA 706 (Revised)¹² establishes mechanisms for auditors of financial statements of all entities to include additional communication in the auditor's report through the use of Emphasis of Matter paragraphs and Other Matter paragraphs when the auditor considers it necessary to do so. In such cases, these paragraphs are presented separately from the Key Audit Matters section in the auditor's report. When a matter has been determined to be a key audit matter, the use of such paragraphs is not a substitute for the description of the individual key audit matter in accordance with paragraph 13¹³. SA 706 (Revised) provides further guidance on the relationship between key audit matters and Emphasis of Matter paragraphs in accordance with that SA.¹⁴

⁹ SA 700(Revised), paragraphs 10–15 and A1–A10.

¹⁰ See paragraph A7 of SA 705 (Revised).

¹¹ SA 705(Revised), paragraph 8.

¹² SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

¹³ See paragraphs 8(b) and 10(b) of SA 706 (Revised).

¹⁴ SA 706 (Revised), paragraphs A1–A3.

I.506 Auditing Pronouncements

Determining Key Audit Matters (Ref: Para. 9–10)

A9. The auditor's decision-making process in determining key audit matters is designed to select a smaller number of matters from the matters communicated with those charged with governance, based on the auditor's judgment about which matters were of most significance in the audit of the financial statements of the current period.

A10. The auditor's determination of key audit matters is limited to those matters of most significance in the audit of the financial statements of the current period, even when comparative financial statements are presented (i.e., even when the auditor's opinion refers to each period for which financial statements are presented).¹⁵

A11. Notwithstanding that the auditor's determination of key audit matters is for the audit of the financial statements of the current period and this SA does not require the auditor to update key audit matters included in the prior period's auditor's report, it may nevertheless be useful for the auditor to consider whether a matter that was a key audit matter in the audit of the financial statements of the prior period continues to be a key audit matter in the audit of the financial statements of the current period.

Matters that Required Significant Auditor Attention (Ref: Para. 9)

A12. The concept of significant auditor attention recognizes that an audit is risk-based and focuses on identifying and assessing the risks of material misstatement of the financial statements, designing and performing audit procedures responsive to those risks, and obtaining audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. For a particular account balance, class of transactions or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In designing further audit procedures, the auditor is required to obtain more persuasive audit evidence the higher the auditor's assessment of risk.¹⁶ When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.¹⁷

A13. Accordingly, matters that pose challenges to the auditor in obtaining sufficient appropriate audit evidence or pose challenges to the auditor in forming an opinion on the financial statements may be particularly relevant in the auditor's determination of key audit matters.

A14. Areas of significant auditor attention often relate to areas of complexity and significant management judgment in the financial statements, and therefore often involve difficult or complex auditor judgments. In turn, this often affects the auditor's overall audit strategy, the allocation of resources and extent of audit effort in relation to such matters. These effects may include, for example, the extent of involvement of senior personnel on the audit engagement or the involvement of an auditor's expert or individuals with expertise in a specialized area of accounting or auditing, whether engaged or employed by the firm to address these areas.

A15. Various SAs require specific communications with those charged with governance and others that may relate to areas of significant auditor attention. For example:

- SA 260 (Revised) requires the auditor to communicate significant difficulties, if any, encountered during the audit with those charged with governance.¹⁸ The SAs acknowledge potential difficulties in relation

¹⁵ See SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*.

¹⁶ SA 330, *The Auditor's Responses to Assessed Risks*, paragraph 7(b).

¹⁷ SA 330, paragraph A19.

¹⁸ SA 260 (Revised), paragraphs 16(b) and A21.

to, for example:

- Related party transactions¹⁹, in particular limitations on the auditor's ability to obtain audit evidence that all other aspects of a related party transaction (other than price) are equivalent to those of a similar arm's length transaction.
- Limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.²⁰
- SA 220 establishes requirements for the engagement partner in relation to undertaking appropriate consultation on difficult or contentious matters.²¹ For example, the auditor may have consulted with others within the firm or outside the firm on a significant technical matter, which may be an indicator that it is a key audit matter. The engagement partner is also required to discuss, among other things, significant matters arising during the audit engagement with the engagement quality control reviewer.²²

Considerations in Determining Those Matters that Required Significant Auditor Attention (Ref: Para. 9)

A16. The auditor may develop a preliminary view at the planning stage about matters that are likely to be areas of significant auditor attention in the audit and therefore may be key audit matters. The auditor may communicate this with those charged with governance when discussing the planned scope and timing of the audit in accordance with SA 260 (Revised). However, the auditor's determination of key audit matters is based on the results of the audit or evidence obtained throughout the audit.

A17. Paragraph 9 includes specific required considerations in the auditor's determination of those matters that required significant auditor attention. These considerations focus on the nature of matters communicated with those charged with governance that are often linked to matters disclosed in the financial statements, and are intended to reflect areas of the audit of the financial statements that may be of particular interest to intended users. The fact that these considerations are required is not intended to imply that matters related to them are always key audit matters; rather, matters related to such specific considerations are key audit matters only if they are determined to be of most significance in the audit in accordance with paragraph 10. As the considerations may be interrelated (e.g., matters relating to the circumstances described in paragraphs 9(b)-(c) may also be identified as significant risks), the applicability of more than one of the considerations to a particular matter communicated with those charged with governance may increase the likelihood of the auditor identifying that matter as a key audit matter.

A18. In addition to matters that relate to the specific required considerations in paragraph 9, there may be other matters communicated with those charged with governance that required significant auditor attention and that therefore may be determined to be key audit matters in accordance with paragraph 10. Such matters may include, for example, matters relevant to the audit that was performed that may not be required to be disclosed in the financial statements. For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular if such a change had a significant effect on the auditor's overall audit strategy or related to a significant risk (e.g., changes to a system affecting revenue recognition).

Areas of Higher Assessed Risk of Material Misstatement, or Significant Risks Identified in Accordance with SA 315 (Ref: Para. 9(a))

A19. SA 260 (Revised) requires the auditor to communicate with those charged with governance about the

¹⁹ SA 550, *Related Parties*, paragraph A42.

²⁰ SA 600, *Using the work of Another Auditor*.

²¹ SA 220, *Quality Control for an Audit of Financial Statements*, paragraph 18.

²² SA 220, paragraph 19.

I.508 Auditing Pronouncements

significant risks identified by the auditor.²³ Paragraph A13 of SA 260 (Revised) explains that the auditor may also communicate with those charged with governance about how the auditor plans to address areas of higher assessed risks of material misstatement.

A20. SA 315 defines a significant risk as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration. Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.

A21. However, this may not be the case for all significant risks. For example, SA 240 presumes that there are risks of fraud in revenue recognition and requires the auditor to treat those assessed risks of material misstatement due to fraud as significant risks.²⁴ In addition, SA 240 indicates that, due to the unpredictable way in which management override of controls could occur, it is a risk of material misstatement due to fraud and thus a significant risk.²⁵ Depending on their nature, these risks may not require significant auditor attention, and therefore would not be considered in the auditor's determination of key audit matters in accordance with paragraph 10.

A22. SA 315 explains that the auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained.²⁶ Revision to the auditor's risk assessment and reevaluation of the planned audit procedures with respect to a particular area of the financial statements (i.e., a significant change in the audit approach, for example, if the auditor's risk assessment was based on an expectation that certain controls were operating effectively and the auditor has obtained audit evidence that they were not operating effectively throughout the audit period, particularly in an area with higher assessed risk of material misstatement) may result in an area being determined as one requiring significant auditor attention.

Significant Auditor Judgments Relating to Areas in the Financial Statements that Involved Significant Management Judgment, Including Accounting Estimates that Have Been Identified as Having High Estimation Uncertainty (Ref: Para. 9(b))

A23. SA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.²⁷ In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.

A24. However, users of the financial statements have highlighted their interest in accounting estimates that have been identified as having high estimation uncertainty in accordance with SA 540²⁸ that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgment and are often the most complex areas of the financial statements, and may require the involvement of both a management's expert and an auditor's expert. Users have also highlighted that accounting policies that have a significant effect on the financial statements (and significant changes to those policies) are relevant to their understanding of the financial statements, especially in circumstances where an

²³ SA 260 (Revised), paragraph 15.

²⁴ SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 26–27.

²⁵ SA 240, paragraph 31.

²⁶ SA 315, *Identifying and Assessing the Risks of Material Misstatement through understanding the Entity and its environment*, paragraph 31.

²⁷ SA 260 (Revised), paragraph 16(a).

²⁸ See paragraphs 10–11 of SA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

entity's practices are not consistent with others in its industry.

The Effect on the Audit of Significant Events or Transactions that Occurred during the Period (Ref: Para. 9(c))

A25. Events or transactions that had a significant effect on the financial statements or the audit may be areas of significant auditor attention and may be identified as significant risks. For example, the auditor may have had extensive discussions with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.²⁹ Management may have made difficult or complex judgments in relation to recognition, measurement, presentation or disclosure of such transactions, which may have had a significant effect on the auditor's overall strategy.

A26. Significant economic, accounting, regulatory, industry, or other developments that affected management's assumptions or judgments may also affect the auditor's overall approach to the audit and result in a matter requiring significant auditor attention.

Matters of Most Significance (Ref: Para. 10)

A27. Matters that required significant auditor attention also may have resulted in significant interaction with those charged with governance. The nature and extent of communication about such matters with those charged with governance often provides an indication of which matters are of most significance in the audit. For example, the auditor may have had more in-depth, frequent or robust interactions with those charged with governance on more difficult and complex matters, such as the application of significant accounting policies that were the subject of significant auditor or management judgment.

A28. The concept of matters of most significance is applicable in the context of the entity and the audit that was performed. As such, the auditor's determination and communication of key audit matters is intended to identify matters specific to the audit and to involve making a judgment about their importance relative to other matters in the audit.

A29. Other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter include:

- The importance of the matter to intended users' understanding of the financial statements as a whole, in particular, its materiality to the financial statements.
- The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry.
- The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any.
- The nature and extent of audit effort needed to address the matter, including:
 - The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
 - The nature of consultations outside the engagement team regarding the matter.
- The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor's opinion, in particular as the auditor's judgments become more subjective.

²⁹ See paragraphs 16(a), 16(c) and A22, and Appendix 2 of SA 260 (Revised).

I.510 Auditing Pronouncements

- The severity of any control deficiencies identified relevant to the matter.
- Whether the matter involved a number of separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation or other contingencies, and may have an effect on other accounting estimates.

A30. Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit of the financial statements of the current period is a matter of professional judgment. The number of key audit matters to be included in the auditor's report may be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstances of the audit engagement. In general, the greater the number of matters initially determined to be key audit matters, the more the auditor may need to reconsider whether each of these matters meets the definition of a key audit matter. Lengthy lists of key audit matters may be contrary to the notion of such matters being those of most significance in the audit.

Communicating Key Audit Matters

Separate Key Audit Matters Section in the Auditor's Report (Ref: Para. 11)

A31. Placing the separate Key Audit Matters section in close proximity to the auditor's opinion may give prominence to such information and acknowledge the perceived value of engagement-specific information to intended users.

A32. The order of presentation of individual matters within the Key Audit Matters section is a matter of professional judgment. For example, such information may be organized in order of relative importance, based on the auditor's judgment, or may correspond to the manner in which matters are disclosed in the financial statements. The requirement in paragraph 11 to include subheadings is intended to further differentiate the matters.

A33. When comparative financial information is presented, the introductory language of the Key Audit Matters section is tailored to draw attention to the fact that the key audit matters described relate to only the audit of the financial statements of the current period, and may include reference to the specific period covered by those financial statements (e.g., "for the year ended March 31, 20X1").

Descriptions of Individual Key Audit Matters (Ref: Para. 13)

A34. The adequacy of the description of a key audit matter is a matter of professional judgment. The description of a key audit matter is intended to provide a succinct and balanced explanation to enable intended users to understand why the matter was one of most significance in the audit and how the matter was addressed in the audit. Limiting the use of highly technical auditing terms also helps to enable intended users who do not have a reasonable knowledge of auditing to understand the basis for the auditor's focus on particular matters during the audit. The nature and extent of information provided by the auditor is intended to be balanced in the context of the responsibilities of the respective parties (i.e., for the auditor to provide useful information in a concise and understandable form, while not inappropriately being the provider of original information about the entity).

A35. Original information is any information about the entity that has not otherwise been made publicly available by the entity (e.g., has not been included in the financial statements or other information available at the date of the auditor's report, or addressed in other oral or written communications by management or those charged with governance, such as a preliminary announcement of financial information or investor briefings). Such information is the responsibility of the entity's management and those charged with governance.

A36. It is appropriate for the auditor to seek to avoid the description of a key audit matter inappropriately providing original information about the entity. The description of a key audit matter is not usually of itself

original information about the entity, as it describes the matter in the context of the audit. However, the auditor may consider it necessary to include additional information to explain why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and how the matter was addressed in the audit, provided that disclosure of such information is not precluded by law or regulation. When such information is determined to be necessary by the auditor, the auditor may encourage management or those charged with governance to disclose additional information, rather than the auditor providing original information in the auditor's report.

A37. Management or those charged with governance may decide to include new or enhanced disclosures in the financial statements or elsewhere in the annual report relating to a key audit matter in light of the fact that the matter will be communicated in the auditor's report. Such new or enhanced disclosures, for example, may be included to provide more robust information about the sensitivity of key assumptions used in accounting estimates or the entity's rationale for a particular accounting practice or policy when acceptable alternatives exist under the applicable financial reporting framework.

A38. Although the auditor's opinion on the financial statements does not extend to the other information addressed by SA 720³⁰ the auditor may consider this information, as well as other publicly available communications by the entity or other credible sources, in formulating the description of a key audit matter.

A39. Audit documentation prepared during the audit can also be useful to the auditor in formulating the description of a key audit matter. For example, written communications, or the auditor's documentation of oral communications, with those charged with governance and other audit documentation provides a useful basis for the auditor's communication in the auditor's report. This is because audit documentation in accordance with SA 230 is intended to address the significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions, and serves as a record of the nature, timing and extent of the audit procedures performed, the results of those procedures, and the audit evidence obtained. Such documentation may assist the auditor in developing a description of key audit matters that explains the significance of the matter and also in applying the requirement in paragraph 18.

Reference to Where the Matter Is Disclosed in the Financial Statements (Ref: Para. 13)

A40. Paragraphs 13(a)-(b) requires the description of each key audit matter to address why the auditor considered the matter to be one of most significance in the audit and how the matter was addressed in the audit. Accordingly, the description of key audit matters is not a mere reiteration of what is disclosed in the financial statements. However, a reference to any related disclosures enables intended users to further understand how management has addressed the matter in preparing the financial statements.

A41. In addition to referring to related disclosure(s), the auditor may draw attention to key aspects of them. The extent of disclosure by management about specific aspects or factors in relation to how a particular matter is affecting the financial statements of the current period may help the auditor in pinpointing particular aspects of how the matter was addressed in the audit such that intended users can understand why the matter is a key audit matter. For example:

- When an entity includes robust disclosure about accounting estimates, the auditor may draw attention to the disclosure of key assumptions, the disclosure of the range of possible outcomes, and other qualitative and quantitative disclosures relating to key sources of estimation uncertainty or critical accounting estimates, as part of addressing why the matter was one of most significance in the audit and how the matter was addressed in the audit.

³⁰ SA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*.

I.512 Auditing Pronouncements

- When the auditor concludes in accordance with SA 570 (Revised) that no material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor may nevertheless determine that one or more matters relating to this conclusion arising from the auditor's work effort under SA 570 (Revised) are key audit matters. In such circumstances, the auditor's description of such key audit matters in the auditor's report could include aspects of the identified events or conditions disclosed in the financial statements, such as substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements, and related mitigating factors.³¹

Why the Auditor Considered the Matter to Be One of Most Significance in the Audit (Ref: Para. 13(a))

A42. The description of a key audit matter in the auditor's report is intended to provide insight as to why the matter was determined to be a key audit matter. Accordingly, the requirements in paragraphs 9–10 and the application material in paragraphs A12–A29 related to determining key audit matters may also be helpful for the auditor in considering how such matters are to be communicated in the auditor's report. For example, explaining the factors that led the auditor to conclude that a particular matter required significant auditor attention and was of most significance in the audit is likely to be of interest to intended users.

A43. The relevance of the information for intended users is a consideration for the auditor in determining what to include in the description of a key audit matter. This may include whether the description would enable a better understanding of the audit and the auditor's judgments.

A44. Relating a matter directly to the specific circumstances of the entity may also help to minimize the potential that such descriptions become overly standardized and less useful over time. For example, certain matters may be determined as key audit matters in a particular industry across a number of entities due to the circumstances of the industry or the underlying complexity in financial reporting. In describing why the auditor considered the matter to be one of most significance, it may be useful for the auditor to highlight aspects specific to the entity (e.g., circumstances that affected the underlying judgments made in the financial statements of the current period) in order to make the description more relevant for intended users. This also may be important in describing a key audit matter that recurs over periods.

A45. The description may also make reference to the principal considerations that led the auditor, in the circumstances of the audit, to determine the matter to be one of most significance, for example:

- Economic conditions that affected the auditor's ability to obtain audit evidence, for example illiquid markets for certain financial instruments.
- New or emerging accounting policies, for example entity-specific or industry-specific matters on which the engagement team consulted within the firm.
- Changes in the entity's strategy or business model that had a material effect on the financial statements.

How the Matter Was Addressed in the Audit (Ref: Para. 13(b))

A46. The amount of detail to be provided in the auditor's report to describe how a key audit matter was addressed in the audit is a matter of professional judgment. In accordance with paragraph 13(b), the auditor may describe:

- Aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement;
- A brief overview of procedures performed;

³¹ See paragraph A3 of SA 570(Revised), Going Concern.

- An indication of the outcome of the auditor's procedures; or
 - Key observations with respect to the matter,
- or some combination of these elements.

Law or regulation or national auditing standards may prescribe a specific form or content for the description of a key audit matter, or may specify the inclusion of one or more of these elements.

A47. In order for intended users to understand the significance of a key audit matter in the context of the audit of the financial statements as a whole, as well as the relationship between key audit matters and other elements of the auditor's report, including the auditor's opinion, care may be necessary so that language used in the description of a key audit matter:

- Does not imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements.
- Relates the matter directly to the specific circumstances of the entity, while avoiding generic or standardized language.
- Takes into account how the matter is addressed in the related disclosure(s) in the financial statements, if any.
- Does not contain or imply discrete opinions on separate elements of the financial statements.

A48. Describing aspects of the auditor's response or approach to a matter, in particular when the audit approach required significant tailoring to the facts and circumstances of the entity, may assist intended users in understanding unusual circumstances and significant auditor judgment required to address the risk of material misstatement. In addition, the audit approach in a particular period may have been influenced by entity-specific circumstances, economic conditions, or industry developments. It may also be useful for the auditor to make reference to the nature and extent of communications with those charged with governance about the matter.

A49. For example, in describing the auditor's approach to an accounting estimate that has been identified as having high estimation uncertainty, such as the valuation of complex financial instruments, the auditor may wish to highlight that the auditor employed or engaged an auditor's expert. Such a reference to the use of an auditor's expert does not reduce the auditor's responsibility for the opinion on the financial statements and is therefore not inconsistent with paragraphs 14–15 of SA 620.³²

A50. There may be challenges in describing the auditor's procedures, particularly in complex, judgmental areas of the audit. In particular, it may be difficult to summarize the procedures performed in a succinct way that adequately communicates the nature and extent of the auditor's response to the assessed risk of material misstatement, and the significant auditor judgments involved. Nonetheless, the auditor may consider it necessary to describe certain procedures performed to communicate how the matter was addressed in the audit. Such description may typically be at a high level, rather than include a detailed description of procedures.

A51. As noted in paragraph A46, the auditor may also provide an indication of the outcome of the auditor's response in the description of the key audit matter in the auditor's report. However, if this is done, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual key audit matter or that in any way may call into question the auditor's opinion on the financial statements as a whole.

Circumstances in Which a Matter Determined to Be a Key Audit Matter is Not Communicated in the Auditor's

³² SA 620, *Using the Work of an Auditor's Expert*.

I.514 Auditing Pronouncements

Report (Ref: Para. 14)

A52. Law or regulation may preclude public disclosure by either management or the auditor about a specific matter determined to be a key audit matter. For example, law or regulation may specifically prohibit any public communication that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act (e.g., matters that are or appear to be related to money laundering).

A53. As indicated by paragraph 14(b), it will be extremely rare for a matter determined to be a key audit matter not to be communicated in the auditor's report. This is because there is presumed to be a public interest benefit in providing greater transparency about the audit for intended users. Accordingly, the judgment not to communicate a key audit matter is appropriate only in cases when the adverse consequences to the entity or the public as a result of such communication are viewed as so significant that they would reasonably be expected to outweigh the public interest benefits of communicating about the matter.

A54. The determination not to communicate a key audit matter takes into account the facts and circumstances related to the matter. Communication with management and those charged with governance helps the auditor understand management's views about the significance of the adverse consequences that may arise as a result of communicating about a matter. In particular, communication with management and those charged with governance helps to inform the auditor's judgment in determining whether to communicate the matter by:

- Assisting the auditor in understanding why the matter has not been publicly disclosed by the entity (e.g., if law, regulation or certain financial reporting frameworks permit delayed disclosure or non-disclosure of the matter) and management's views as to the adverse consequences, if any, of disclosure. Management may draw attention to certain aspects in law or regulation or other authoritative sources that may be relevant to the consideration of adverse consequences (e.g., such aspects may include harm to the entity's commercial negotiations or competitive position). However, management's views about the adverse consequences alone do not alleviate the need for the auditor to determine whether the adverse consequences would reasonably be expected to outweigh the public interest benefits of communication in accordance with paragraph 14(b).
- Highlighting whether there have been any communications with applicable regulatory, enforcement or supervisory authorities in relation to the matter, in particular whether such discussions would appear to support management's assertion as to why public disclosure about the matter is not appropriate.
- Enabling the auditor, where appropriate, to encourage management and those charged with governance to make public disclosure of relevant information about the matter. In particular, this may be possible if the concerns of management and those charged with governance about communicating are limited to specific aspects relating to the matter, such that certain information about the matter may be less sensitive and could be communicated.

The auditor also may consider it necessary to obtain a written representation from management as to why public disclosure about the matter is not appropriate, including management's view about the significance of the adverse consequences that may arise as a result of such communication.

A55. It may also be necessary for the auditor to consider the implications of communicating about a matter determined to be a key audit matter in light of relevant ethical requirements. In addition, the auditor may be required by law or regulation to communicate with applicable regulatory, enforcement or supervisory authorities in relation to the matter, regardless of whether the matter is communicated in the auditor's report. Such communication may also be useful to inform the auditor's consideration of the adverse consequences that may arise from communicating about the matter.

A56. The issues considered by the auditor regarding a decision to not communicate a matter are complex and involve significant auditor judgment. Accordingly, the auditor may consider it appropriate to obtain legal advice.

Form and Content of the Key Audit Matters Section in Other Circumstances (Ref: Para. 16)

A57. The requirement in paragraph 16 applies in three circumstances:

- (i) The auditor determines in accordance with paragraph 10 that there are no key audit matters (see paragraph A59).
- (ii) The auditor determines in accordance with paragraph 14 that a key audit matter will not be communicated in the auditor's report and no other matters have been determined to be key audit matters.
- (iii) The only matters determined to be key audit matters are those communicated in accordance with paragraph 15.

A58. The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

[Except for the matter described in the *Basis for Qualified (Adverse) Opinion* section or *Material Uncertainty Related to Going Concern* section,] We have determined that there are no [other] key audit matters to communicate in our report.

A59. The determination of key audit matters involves making a judgment about the relative importance of matters that required significant auditor attention. Therefore, it may be rare that the auditor of a complete set of general purpose financial statements of a listed entity would not determine at least one key audit matter from the matters communicated with those charged with governance to be communicated in the auditor's report. However, in certain limited circumstances (e.g., for a listed entity that has very limited operations), the auditor may determine that there are no key audit matters in accordance with paragraph 10 because there are no matters that required significant auditor attention.

Communication with Those Charged with Governance (Ref: Para. 17)

A60. SA 260 (Revised) requires the auditor to communicate with those charged with governance on a timely basis.³³ The appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

A61. Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion. Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be

³³ SA 260 (Revised), paragraph 21.

I.516 Auditing Pronouncements

useful in light of the fact that these matters will be communicated in the auditor's report.

A62. The communication with those charged with governance required by paragraph 17(a) also addresses the extremely rare circumstances in which a matter determined to be a key audit matter is not communicated in the auditor's report (see paragraphs 14 and A54).

A63. The requirement in paragraph 17(b) to communicate with those charged with governance when the auditor has determined there are no key audit matters to communicate in the auditor's report may provide an opportunity for the auditor to have further discussion with others who are familiar with the audit and the significant matters that may have arisen (including the engagement quality control reviewer, where one has been appointed). These discussions may cause the auditor to re-evaluate the auditor's determination that there are no key audit matters.

Documentation (Ref: Para. 18)

A64. Paragraph 8 of SA 230 requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, significant professional judgments. In the context of key audit matters, these professional judgments include the determination, from the matters communicated with those charged with governance, of the matters that required significant auditor attention, as well as whether or not each of those matters is a key audit matter. The auditor's judgments in this regard are likely to be supported by the documentation of the auditor's communications with those charged with governance and the audit documentation relating to each individual matter (see paragraph A39), as well as certain other audit documentation of the significant matters arising during the audit (e.g., a completion memorandum). However, this SA does not require the auditor to document why other matters communicated with those charged with governance were not matters that required significant auditor attention.

SA 705

Modifications to the Opinion in the Independent Auditor's Report
(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised),¹ the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion. In all cases, the reporting requirements in SA 700 (Revised) apply, and are not repeated in this SA unless they are explicitly addressed or amended by the requirements of this SA.

Types of Modified Opinions

2. This SA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements. (Ref: Para. A1)

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objective

4. The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if

¹ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

I.518 Auditing Pronouncements

any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- (i) Are not confined to specific elements, accounts or items of the financial statements;
 - (ii) If so confined, represent or could represent a substantial proportion of the financial statements;
or
 - (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.
- (b) Modified opinion – A qualified opinion, an adverse opinion or a disclaimer of opinion on the financial statements.

Requirements

Circumstances When a Modification to the Auditor's Opinion is Required

6. The auditor shall modify the opinion in the auditor's report when:
- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (Ref: Para. A2–A7)
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. (Ref: Para. A8– A12)

Determining the Type of Modification to the Auditor's Opinion

Qualified Opinion

7. The auditor shall express a qualified opinion when:
- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion

8. The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion

9. The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

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

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement

11. If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management

remove the limitation.

12. If management refuses to remove the limitation referred to in paragraph 11 of this SA, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity,² and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

13. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- (b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
 - (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or (Ref: Para. A13)
 - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements. (Ref. Para. A14)

14. If the auditor withdraws as contemplated by paragraph 13(b)(i), before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. (Ref: Para. A15)

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion

15. When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report³ in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole. (Ref: Para. A16)

Form and Content of the Auditor's Report When the Opinion is Modified

Auditor's Opinion

16. When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section. (Ref: Para. A17–A19)

Qualified Opinion

17. When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or

² SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

³ SA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, deals with circumstances where the auditor is engaged to express a separate opinion on one or more specific elements, accounts or items of a financial statement.

I.520 Auditing Pronouncements

- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase “except for the possible effects of the matter(s) ...” for the modified opinion. (Ref: Para. A20)

Adverse Opinion

18. When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor’s opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

Disclaimer of Opinion

19. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- (a) State that the auditor does not express an opinion on the accompanying financial statements;
- (b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) Amend the statement required by paragraph 24(b) of SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Basis for Opinion

20. When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised): (Ref: Para. A21)

- (a) Amend the heading “Basis for Opinion” required by paragraph 28 of SA 700 (Revised) to “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion,” as appropriate; and
- (b) Within this section, include a description of the matter giving rise to the modification.

21. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section. (Ref: Para. A22)

22. If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

23. If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- (a) Discuss the non-disclosure with those charged with governance;

- (b) Describe in the Basis for Opinion section the nature of the omitted information; and
 - (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information. (Ref: Para. A23)
24. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.
25. When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by paragraph 28(d) of SA 700 (Revised) to include the word "qualified" or "adverse", as appropriate.
26. When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the elements required by paragraphs 28(b) and 28(d) of SA 700 (Revised). Those elements are:
- (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
 - (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
27. Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof. (Ref: Para. A24)

Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements

28. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by paragraphs 38–40 of SA 700 (Revised) to include only the following: (Ref: Para. A25)
- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
 - (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
 - (c) The statement about auditor independence and other ethical responsibilities required by paragraph 28(c) of SA 700 (Revised).

Considerations When the Auditor Disclaims an Opinion on the Financial Statements

- Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.⁴ (Ref: Para. A26)

Communication with Those Charged with Governance

- When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification. (Ref: Para. A27)

⁴ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraphs 11–13

Application and Other Explanatory Material

Types of Modified Opinions (Ref: Para. 2)

A1. The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements Are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Circumstances When a Modification to the Auditor's Opinion is Required

Nature of Material Misstatements (Ref: Para. 6(a))

A2. SA 700 (Revised) requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement.⁵ This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with SA 450.⁶

A3. SA 450 defines a misstatement as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to:

- (a) The appropriateness of the selected accounting policies;
- (b) The application of the selected accounting policies; or
- (c) The appropriateness or adequacy of disclosures in the financial statements.

Appropriateness of the Selected Accounting Policies

A4. In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when:

- (a) The selected accounting policies are not consistent with the applicable financial reporting framework; or
- (b) The financial statements, including the related notes, do not represent the underlying transactions and

⁵ SA 700 (Revised), paragraph 11

⁶ SA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

events in a manner that achieves fair presentation.

A5. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements.

Application of the Selected Accounting Policies

A6. In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

- (a) When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
- (b) Due to the method of application of the selected accounting policies (such as an unintentional error in application).

Appropriateness or Adequacy of Disclosures in the Financial Statements

A7. In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

- (a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
- (b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
- (c) The financial statements do not provide the disclosures necessary to achieve fair presentation.

Nature of an Inability to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 6(b))

A8. The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- (a) Circumstances beyond the control of the entity;
- (b) Circumstances relating to the nature or timing of the auditor's work; or
- (c) Limitations imposed by management.

A9. An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the requirements of paragraphs 7(b) and 9–10 apply as appropriate. Limitations imposed by management may have other implications for the audit, such as for the auditor's assessment of fraud risks and consideration of engagement continuance.

A10. Examples of circumstances beyond the control of the entity include when:

- The entity's accounting records have been destroyed.
- The accounting records of a significant component have been seized indefinitely by governmental authorities.

A11. Examples of circumstances relating to the nature or timing of the auditor's work include when:

- The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.

I.524 Auditing Pronouncements

- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

A12. Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management prevents the auditor from observing the counting of the physical inventory.
- Management prevents the auditor from requesting external confirmation of specific account balances.

Determining the Type of Modification to the Auditor's Opinion

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement (Ref: Para. 13(b)(i)–14)

A13. The practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation within the Basis for Disclaimer of Opinion section prior to withdrawing.

A14. In certain circumstances, withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor that is appointed to audit the financial statements of public sector entities. It may also be the case in entities where the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. The auditor may also consider it necessary to include an Other Matter paragraph in the auditor's report.⁷

A15. When the auditor concludes that withdrawal from the audit is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion (Ref: Para. 15)

A16. The following are examples of reporting circumstances that would not contradict the auditor's adverse opinion or disclaimer of opinion:

- The expression of an unmodified opinion on financial statements prepared under a given financial reporting framework and, within the same report, the expression of an adverse opinion on the same financial statements under a different financial reporting framework.⁸
- The expression of a disclaimer of opinion regarding the results of operations, and cash flows, where relevant, and an unmodified opinion regarding the financial position (see SA 510⁹). In this case, the auditor has not expressed a disclaimer of opinion on the financial statements as a whole.

Form and Content of the Auditor's Report When the Opinion Is Modified

Illustrative Auditor's Reports (Ref: Para. 16)

A17. Illustrations 1 and 2 in the Appendix contain auditor's reports with qualified and adverse opinions, respectively, as the financial statements are materially misstated.

⁷ SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph A10

⁸ See paragraph A25 of SA 700 (Revised) for a description of this circumstance.

⁹ SA 510, *Initial Audit Engagements – Opening Balances*, paragraph 10 and A5

A18. Illustration 3 in the Appendix contains an auditor's report with a qualified opinion as the auditor is unable to obtain sufficient appropriate audit evidence. Illustration 4 contains a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about a single element of the financial statements. Illustration 5 contains a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. In each of the latter two cases, the possible effects on the financial statements of the inability are both material and pervasive. The Appendices to other SAs that include reporting requirements, including SA 570 (Revised),¹⁰ also include illustrations of auditor's reports with modified opinions.

Auditor's Opinion (Ref: Para. 16)

A19. Amending this heading makes it clear to the user that the auditor's opinion is modified and indicates the type of modification.

Qualified Opinion (Ref: Para. 17)

A20. When the auditor expresses a qualified opinion, it would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the Opinion section as these are not sufficiently clear or forceful.

Basis for Opinion (Ref: Para. 20, 21, 23, 27)

A21. Consistency in the auditor's report helps to promote users' understanding and to identify unusual circumstances when they occur. Accordingly, although uniformity in the wording of a modified opinion and in the description of the reasons for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.

A22. An example of the financial effects of material misstatements that the auditor may describe within the Basis for Opinion section in the auditor's report is the quantification of the effects on income tax, income before taxes, net income and equity if inventory is overstated.

A23. Disclosing the omitted information within the Basis for Opinion section would not be practicable if:

- (a) The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
- (b) In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report.

A24. An adverse opinion or a disclaimer of opinion relating to a specific matter described within the Basis for Opinion section does not justify the omission of a description of other identified matters that would have otherwise required a modification of the auditor's opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements.

Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements (Ref: Para. 28)

A25. When the auditor disclaims an opinion on the financial statements, the following statements are better positioned within the Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report, as illustrated in Illustrations 4–5 of the Appendix to this SA:

- The statement required by paragraph 28(a) of SA 700 (Revised), amended to state that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with SAs; and
- The statement required by paragraph 28(c) of SA 700 (Revised) about independence and other ethical responsibilities.

¹⁰ SA 570 (Revised), *Going Concern*

I.526 Auditing Pronouncements

Considerations When the Auditor Disclaims an Opinion on the Financial Statements (Ref: Para. 29)

A26. Providing the reasons for the auditor's inability to obtain sufficient appropriate audit evidence within the Basis for Disclaimer of Opinion section of the auditor's report provides useful information to users in understanding why the auditor has disclaimed an opinion on the financial statements and may further guard against inappropriate reliance on them. However, communication of any key audit matters other than the matter(s) giving rise to the disclaimer of opinion may suggest that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, and would be inconsistent with the disclaimer of opinion on the financial statements as a whole. Accordingly, paragraph 29 of this SA prohibits a Key Audit Matters section from being included in the auditor's report when the auditor disclaims an opinion on the financial statements, unless the auditor is otherwise required by law or regulation to communicate key audit matters.

Communication with Those Charged with Governance (Ref: Para. 30)

A27. Communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the wording of the modification enables:

- The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);
- The auditor to seek the concurrence of those charged with governance regarding the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and
- Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

Appendix

(Ref: Para. A17–A18, A25)

Illustrations of Auditor's Reports with Modifications to the Opinion

- Illustration 1: An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.
- Illustration 2: An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- Illustration 3: An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- Illustration 4: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.
- Illustration 5: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

Illustration 1 – Qualified Opinion due to a Material Misstatement of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework.*
- *The financial statements are prepared by management of the entity in accordance with the Accounting*

Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).

- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.¹¹*
- *Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Key audit matters have been communicated in accordance with SA 701.*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹²

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)¹³ and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (*location of branches*))¹⁴.

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 20XX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards prescribed under section 133 of the Companies Act, 2013. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of Rs. xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by Rs. xxx, and income tax, net income and shareholders' funds would have been reduced by Rs. xxx, Rs. xxx and Rs. xxx, respectively.

¹¹ SA 210, *Agreeing the Terms of Audit Engagements*

¹² The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹³ As may be applicable.

¹⁴ As may be applicable.

I.528 Auditing Pronouncements

We conducted our audit in accordance with Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with SA 701.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Other Matter¹⁵

We did not audit the financial statements/information of _____(number) branches included in the standalone financial statements of the Company whose financial statements / financial information reflect total assets of Rs._____ as at 31st March, 20XX and total revenues of Rs._____ for the year ended on that date, as considered in the standalone financial statements. The financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of this matter.

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁵ Where applicable.

¹⁶ Partner or Proprietor, as the case may be

Illustration 2 – Adverse Opinion due to a Material Misstatement of the Consolidated Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of a listed company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.
- The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).
- The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- SA 701 applies; however, the auditor has determined that there are no key audit matters other than the matter described in the Basis for Adverse Opinion section.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Consolidated Financial Statements¹⁷**Adverse Opinion**

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2XXX, the consolidated statement of profit and Loss, (consolidated statement of changes in equity)¹⁸ and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, because

¹⁷ The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁸ Where applicable.

I.530 Auditing Pronouncements

of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 20XX, of its consolidated profit/loss, (*consolidated position of changes in equity*)¹⁹ and the consolidated cash flows for the year then ended.

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20XX because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under the accounting principles generally accepted in India, the Group should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group, its associates and jointly controlled entities, in accordance with the Code of Ethics and provisions of the Companies Act, 2013 that are relevant to our audit of the consolidated financial statements in India under the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with the Code of Ethics and the requirements under the Companies act, 2013. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Key Audit Matters

Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements²⁰

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation²¹)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁹ Where applicable.

²⁰ Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

²¹ Partner or Proprietor, as the case may be

Illustration 3 – Qualified Opinion due to the Auditor's Inability to Obtain Sufficient Audit Evidence Regarding a Foreign Associate

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of a listed Company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries, associates and jointly controlled entities (i.e., SA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the consolidated financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the relevant provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Consolidated Financial Statements²²**Qualified Opinion**

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 20XX, and the consolidated statement of Profit and Loss, (*consolidated statement of changes in equity*)²³ and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as "the consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid consolidated financial statements give a true and fair view in conformity with the accounting

²² The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²³ Where applicable.

I.532 Auditing Pronouncements

principles generally accepted in India, of their consolidated state of affairs as at March 31, 2XXX, consolidated profit/loss, (*consolidated changes in equity*)²⁴, consolidated cash flows for the year then ended.

Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. xxx on the consolidated balance sheet as at March 31, 20XX, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at March 31, 2XXX and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with Standards on Auditing (SAs) prescribed under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group and its associates and joint ventures in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in India in terms of the Code of Ethics issued by the Institute of Chartered Accountants of India and the relevant provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with SA 701.]

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements²⁵

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

²⁴ Where applicable.

²⁵ Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation²⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 4 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about a Single Element of the Consolidated Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of consolidated financial statements of an unlisted Company incorporated under the Companies Act, 2013 using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).*
- *The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013(a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.*
- *The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the consolidated financial statements (i.e., a disclaimer of opinion is appropriate).*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and provisions of the Companies Act, 2013.*
- *Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.*
- *A more limited description of the auditor's responsibilities section is required.*
- *In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013*

²⁶ Partner or Proprietor, as the case may be

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Consolidated Financial Statements²⁷

Disclaimer of Opinion

We were engaged to audit the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), which comprise the consolidated balance sheet as at March 31, 20XX, the consolidated statement of Profit and Loss, (*consolidated statement of changes in equity*)²⁸ and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "Consolidated Financial Statements").

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at Rs. xxx on the Group's consolidated balance sheet, which represents over 90% of the Group's net assets as at March 31, 20XX. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, (*and the elements making up the consolidated statement of changes in equity*)²⁹ and the consolidated cash flow statement.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements³⁰

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with Standards on Auditing and to issue an auditor's report. However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements and we have fulfilled our other ethical responsibilities in accordance with these requirements.

²⁷ The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²⁸ Where applicable.

²⁹ Where applicable.

³⁰ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation³¹)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 5 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of an entity other than a company incorporated under the Companies Act, 2013, using a fair presentation framework. The audit is not a group audit (i.e., SA 600, does not apply).*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.*
- *The relevant ethical requirements that apply to the audit are ICAI's Code of Ethics and applicable law/regulation*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *A more limited description of the auditor's responsibilities section is required.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under relevant law/ regulation.*

³¹ Partner or Proprietor, as the case may be

INDEPENDENT AUDITOR'S REPORT

To the Partners of ABC & Associates

Report on the Audit of the Financial Statements³²

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, *(the statement of changes in equity)*³³ and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after March 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and 20X1, which are stated in the Balance Sheets at Rs xxx and Rs xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of Rs xxx as at March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of Profit and Loss *(and statement of cash flows)*³⁴.

Responsibilities of Management and Those Charged with Governance for the Financial Statements³⁵

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the entity in accordance with the ethical requirements in accordance with the requirements of the Code of Ethics issued by ICAI and the ethical requirements as prescribed under the laws and regulations applicable to the entity.

³² The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

³³ Where applicable.

³⁴ Where applicable.

³⁵ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation³⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

³⁶ Partner or Proprietor, as the case may be

SA 706

Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with additional communication in the auditor's report when the auditor considers it necessary to:
 - (a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
 - (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
2. SA 701¹ establishes requirements and provides guidance when the auditor determines key audit matters and communicates them in the auditor's report. When the auditor includes a Key Audit Matters section in the auditor's report, this SA addresses the relationship between key audit matters and any additional communication in the auditor's report in accordance with this SA. (Ref: Para. A1–A3)
3. SA 570 (Revised)² establishes requirements and provides guidance about communication in the auditor's report relating to going concern.
4. Appendices 1 and 2 identify SAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form of such paragraphs apply. (Ref: Para. A4)

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objective

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

¹ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

² SA 570 (Revised), *Going Concern*

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) **Emphasis of Matter paragraph** – A paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to users’ understanding of the financial statements.
 - (b) **Other Matter paragraph** – A paragraph included in the auditor’s report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor’s judgment, is relevant to users’ understanding of the audit, the auditor’s responsibilities or the auditor’s report.

Requirements

Emphasis of Matter Paragraphs in the Auditor’s Report

8. If the auditor considers it necessary to draw users’ attention to a matter presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to users’ understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor’s report provided: (Ref: Para. A5–A6)

- (a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised)³ as a result of the matter; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor’s report. (Ref: Para. A1–A3)

9. When the auditor includes an Emphasis of Matter paragraph in the auditor’s report, the auditor shall:

- (a) Include the paragraph within a separate section of the auditor’s report with an appropriate heading that includes the term “Emphasis of Matter”;
- (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) Indicate that the auditor’s opinion is not modified in respect of the matter emphasized. (Ref: Para. A7–A8, A16–A17)

Other Matter Paragraphs in the Auditor’s Report

10. If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor’s judgment, is relevant to users’ understanding of the audit, the auditor’s responsibilities or the auditor’s report, the auditor shall include an Other Matter paragraph in the auditor’s report, provided:

- (a) This is not prohibited by law or regulation; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor’s report. (Ref: Para. A9–A14)

11. When the auditor includes an Other Matter paragraph in the auditor’s report, the auditor shall include the paragraph within a separate section with the heading “Other Matter,” or other appropriate heading. (Ref: Para. A15–A17)

Communication with Those Charged with Governance

12. If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor’s

³ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*

report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph. (Ref: Para. A18)

Application and Other Explanatory Material

The Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report (Ref: Para. 2, 8(b))

A1. Key audit matters are defined in SA 701 as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance, which include significant findings from the audit of the financial statements of the current period.⁴ Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements. When SA 701 applies, the use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters.

A2. Matters that are determined to be key audit matters in accordance with SA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with SA 701, the auditor may wish to highlight or draw further attention to its relative importance. The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.

A3. There may be a matter that is not determined to be a key audit matter in accordance with SA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this SA.

Circumstances in Which an Emphasis of Matter Paragraph May Be Necessary (Ref: Para. 4, 8)

A4. Appendix 1 identifies SAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor's report in certain circumstances. These circumstances include:

- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- To alert users that the financial statements are prepared in accordance with a special purpose framework.
- When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).⁵

A5. Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.

⁴ SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16.

⁵ SA 560, *Subsequent Events*, paragraphs 12(b) and 16

- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.⁶
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

A6. However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

Including an Emphasis of Matter Paragraph in the Auditor's Report (Ref: Para. 9)

A7. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. An Emphasis of Matter paragraph is not a substitute for:

- (a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;
- (b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
- (c) Reporting in accordance with SA 570 (Revised)⁷ when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

A8. Paragraphs A16–A17 provide further guidance on the placement of Emphasis of Matter paragraphs in particular circumstances.

Other Matter Paragraphs in the Auditor's Report (Ref: Para. 10–11)

Circumstances in Which an Other Matter Paragraph May Be Necessary

Relevant to Users' Understanding of the Audit

A9. SA 260 (Revised) requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit, which includes communication about the significant risks identified by the auditor.⁸ Although matters relating to significant risks may be determined to be key audit matters, other planning and scoping matters (e.g., the planned scope of the audit, or the application of materiality in the context of the audit) are unlikely to be key audit matters because of how key audit matters are defined in SA 701. However, law or regulation may require the auditor to communicate about planning and scoping matters in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph.

A10. In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive,⁹ the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report

⁶ SA 560, paragraph 6

⁷ SA 570 (Revised), paragraphs 22–23

⁸ SA 260 (Revised), paragraph 15

⁹ See paragraph 13(b)(ii) of SA 705 (Revised) for a discussion of this circumstance.

I.542 Auditing Pronouncements

A11. Law, regulation or generally accepted practice may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. When the Other Matter section includes more than one matter that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, it may be helpful to use different sub-headings for each matter.

A12. An Other Matter paragraph does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the SAs (see Other Reporting Responsibilities section in SA 700 (Revised)¹⁰), or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.

Reporting on more than one set of financial statements

A13. An entity may prepare one set of financial statements in accordance with a general purpose framework (e.g., the national framework) and another set of financial statements in accordance with another general purpose framework (e.g., International Financial Reporting Standards), and engage the auditor to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

Restriction on distribution or use of the auditor's report

A14. Financial statements prepared for a specific purpose may be prepared in accordance with a general purpose framework because the intended users have determined that such general purpose financial statements meet their financial information needs. Since the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

Including an Other Matter Paragraph in the Auditor's Report

A15. The content of an Other Matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An Other Matter paragraph does not include information that the auditor is prohibited from providing by law, regulation or other professional standards, for example, ethical standards relating to confidentiality of information. An Other Matter paragraph also does not include information that is required to be provided by management.

Placement of Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditor's Report
(Ref: Para. 9, 11)

A16. The placement of an Emphasis of Matter paragraph or Other Matter paragraph in the auditor's report depends on the nature of the information to be communicated, and the auditor's judgment as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with SA 700 (Revised). For example:

Emphasis of Matter Paragraphs

- When the Emphasis of Matter paragraph relates to the applicable financial reporting framework, including circumstances where the auditor determines that the financial reporting framework prescribed

¹⁰ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 42–44.

by law or regulation would otherwise be unacceptable,¹¹ the auditor may consider it necessary to place the paragraph immediately following the Basis of Opinion section to provide appropriate context to the auditor's opinion.

- When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph. The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Other Matter Paragraphs

- When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.
- When an Other Matter paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.
- When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

A17. Appendix 3 is an illustration of the interaction between the Key Audit Matters section, an Emphasis of Matter paragraph and an Other Matter paragraph when all are presented in the auditor's report. The illustrative report in Appendix 4 includes an Emphasis of Matter paragraph in an auditor's report for an entity other than a listed entity that contains a qualified opinion and for which key audit matters have not been communicated.

Communication with Those Charged with Governance (Ref. Para. 12)

A18. The communication required by paragraph 12 enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor's report, and provides them with an opportunity to obtain further clarification from the auditor where necessary. Where the inclusion of an Other Matter paragraph on a particular matter in the auditor's report recurs on each successive engagement, the auditor may determine that it is unnecessary to repeat the communication on each engagement, unless otherwise required to do so by law or regulation.

Appendix 1

(Ref: Para. 4, A4)

List of SAs Containing Requirements for Emphasis of Matter Paragraphs

This appendix identifies paragraphs in other SAs that require the auditor to include an Emphasis of Matter paragraph in the auditor's report in certain circumstances. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SA 210, *Agreeing the Terms of Audit Engagements* – paragraph 19(b)

¹¹ For example, as required by SA 210, *Agreeing the Terms of Audit Engagements*, paragraph 19 and SA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 14

I.544 Auditing Pronouncements

- SA 560, *Subsequent Events* – paragraphs 12(b) and 16
- SA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* – paragraph 14

Appendix 2

(Ref: Para. 4)

List of SAs Containing Requirements for Other Matter Paragraphs

This appendix identifies paragraphs in other SAs that require the auditor to include an Other Matter paragraph in the auditor's report in certain circumstances. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SA 560, *Subsequent Events* – paragraphs 12(b) and 16
- SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraphs 13–14, 16–17 and 19
- SA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* – paragraph 10(a)

Appendix 3

(Ref: Para. A17)

Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of a listed company (registered under the companies Act, 2013) using a fair presentation framework.*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.*
- *The relevant ethical requirements that apply to the audit are those of the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.*
- *Key audit matters have been communicated in accordance with SA 701.*
- *Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor*

auditor's report on the corresponding figures and has decided to do so.

- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹²

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)¹³.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view*, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter¹⁴

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

¹² 1 The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹³ As may be applicable

¹⁴ As noted in paragraph A16, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

I.546 Auditing Pronouncements

Other Matter

The financial statements of ABC Company for the year ended March 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation ¹⁵)
(Membership No. XXXXX)

Place of Signature:

Date:

Appendix 4 (Ref: Para. A8)

Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of an company other than a listed company (registered under the Companies Act, 2013) using a fair presentation framework..*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *A departure from the applicable financial reporting framework resulted in a qualified opinion.*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*

¹⁵ Partner or Proprietor, as the case may be

- *Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.*
- *The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹⁶

Qualified Opinion

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches))².

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements present fairly, in all material respects, or *give a true and fair view* in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at March 31st, 20XX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from the Accounting Standards prescribed in section 133 of the Companies Act, 2013. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of Rs.xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at March 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by Rs.xxx, Rs.xxx and Rs.xxx, respectively.

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of

¹⁶ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

I.548 Auditing Pronouncements

Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Emphasis of Matter – Effects of a Fire

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700(Revised)–see Illustration 1 in SA 700(Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700(Revised) – see Illustration 1 in SA 700(Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation¹⁷)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁷ Partner or Proprietor, as the case may be

SA 710*

**Comparative Information—Corresponding Figures
and Comparative Financial Statements**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2011)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510¹ regarding opening balances also apply.

The Nature of Comparative Information

2. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures² and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

3. The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

This SA addresses separately the auditor's reporting requirements for each approach.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objectives

5. The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
- (b) To report in accordance with the auditor's reporting responsibilities.

* Published in the April, 2010 issue of the Journal.

¹ SA 510, "Initial Audit Engagements—Opening Balances".

² Typically, financial reporting frameworks in India use the corresponding figures approach for general purpose financial statements.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
 - (b) Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
 - (c) Comparative financial statements – Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor’s opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

For purposes of this SA, references to “prior period” should be read as “prior periods” when the comparative information includes amounts and disclosures for more than one period.

Requirements

Audit Procedures

7. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:
- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
 - (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
8. If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period’s financial statements, the auditor shall also follow the relevant requirements of SA 560³.
9. As required by SA 580⁴, the auditor shall request written representations for all periods referred to in the auditor’s opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year’s statement of profit and loss. (Ref: Para. A1)

Audit Reporting

Corresponding Figures

10. When corresponding figures are presented, the auditor’s opinion shall not refer to the corresponding figures except in the circumstances described in paragraphs 11, 12, and 14. (Ref: Para. A2)
11. If the auditor’s report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor

³ SA 560, “Subsequent Events”, paragraphs 14-17.

⁴ SA 580, “Written Representations”, paragraph 14.

shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures. (Ref: Para. A3-A5)

12. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein. (Ref: Para. A6)

Prior Period Financial Statements Audited by a Predecessor Auditor

13. If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

- (a) That the financial statements of the prior period were audited by the predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (c) The date of that report. (Ref: Para. A7)

Prior Period Financial Statements Not Audited

14. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements⁵. (Ref: Para. A7a)

Comparative Financial Statements

15. When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. (Ref: Para. A8-A9)

16. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706⁶. (Ref: Para. A10)

Prior Period Financial Statements Audited by a Predecessor Auditor

17. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

⁵ SA 510, paragraph 6.

⁶ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

I.552 Auditing Pronouncements

- (a) That the financial statements of the prior period were audited by a predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
- (c) The date of that report,

unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

18. If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period. (Ref: Para. A11)

Prior Period Financial Statements Not Audited

19. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements⁷.

Application and Other Explanatory Material

Audit Procedures

Written Representations (Ref: Para. 9)

A1. In the case of comparative financial statements, the written representations are requested for all periods referred to in the auditor's opinion because management needs to re-affirm that the written representations it previously made with respect to the prior period remain appropriate. In the case of corresponding figures, the written representations are requested for the financial statements of the current period only because the auditor's opinion is on those financial statements, which include the corresponding figures. However, the auditor requests a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

Audit Reporting

Corresponding Figures

No Reference in Auditor's Opinion (Ref: Para.10)

A2. The auditor's opinion does not refer to the corresponding figures because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

Modification in Auditor's Report on the Prior Period Unresolved (Ref: Para. 11)

A3. When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

A4. When the auditor's opinion on the prior period, as previously expressed, was modified, the unresolved matter that gave rise to the modification may not be relevant to the current period figures. Nevertheless, a

⁷ SA 510, paragraph 6.

qualified opinion, a disclaimer of opinion, or an adverse opinion (as applicable) may be required on the current period's financial statements because of the effects or possible effects of the unresolved matter on the comparability of the current and corresponding figures.

A5. Illustrative examples of the auditor's report if the auditor's report on the prior period included a modified opinion and the matter giving rise to the modification is unresolved are contained in Examples A and B of the Appendix.

Misstatement in Prior Period Financial Statements (Ref: Para. 12)

A6. When the prior period financial statements that are misstated have not been amended and an auditor's report thereon has not been issued in accordance with the requirements of SA 560, "Subsequent Events", but the corresponding figures have been properly dealt with as required under the applicable financial reporting framework and the appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to, where relevant, disclosures that fully describe the matter that can be found in the financial statements (see SA 706).

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 13)

A7. An illustrative example of the auditor's report if the prior period financial statements were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures is contained in Example C of the Appendix.

Prior Period Financial Statements Not Audited (Ref: Para.14)

A7a. Where prior period financial statements were not audited, the auditor should request the management to disclose this fact on the face of the current period financial statements with respect to the corresponding figures.

Comparative Financial Statements

Reference in Auditor's Opinion (Ref: Para. 15)

A8. Because the auditor's report on comparative financial statements applies to the financial statements for each of the periods presented, the auditor may express a qualified opinion or an adverse opinion, disclaim an opinion, or include an Emphasis of Matter paragraph with respect to one or more periods, while expressing a different auditor's opinion on the financial statements of the other period.

A9. An illustrative example of the auditor's report if the auditor is required to report on both the current and the prior period financial statements in connection with the current year's audit and the prior period included a modified opinion and the matter giving rise to the modification is unresolved, is contained in Example D of the Appendix.

Opinion on Prior Period Financial Statements Different from Previous Opinion (Ref: Para. 16)

A10. When reporting on the prior period financial statements in connection with the current period's audit, the opinion expressed on the prior period financial statements may be different from the opinion previously expressed if the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period. In some circumstances, the auditor may have additional reporting responsibilities designed to prevent future reliance on the auditor's previously issued report on the prior period financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 18)

A11. The predecessor auditor may be unable or unwilling to revise the auditor's report on the prior period financial statements. An Other Matter paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before amendment. In addition, if the auditor is

I.554 Auditing Pronouncements

engaged to audit and obtains sufficient appropriate audit evidence to be satisfied as to the appropriateness of the amendment, the auditor's report may also include the following paragraph:

As part of our audit of the 20X2 financial statements, we also audited the adjustments described in Note X that were applied to amend the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

Material Modifications *vis-a-vis* ISA 710, "Comparative Information—Corresponding Figures and Comparative Financial Statements"

Deletions

1. Paragraphs 9 and 12 of ISA 710 deal with the restatement of the prior period financial statements. Since in India, Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss. Corresponding changes have also been made at the relevant places of the Standard.

2. Paragraph 17 of ISA 710 deals with the situation wherein the predecessor auditor reissue his audit report. Since in India, the nomenclature, "Reissue" is not used for the re-issuance of the audit report by an auditor, the same has been replaced with the word, "Revised". Corresponding changes have also been made at the relevant places of the Standard.

Appendix

Example Auditors' Reports

Example A - Corresponding Figures (Ref: Para. A5)

Report illustrative of the circumstances described in paragraph 11(a), as follows:

- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are material and require a modification to the auditor's opinion regarding the current period figures.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements⁸

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

⁸ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control⁹. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by ₹ XXX in 20X1 and ₹ XXX in 20X0, property, plant and equipment should be reduced by accumulated depreciation of ₹ XXX in 20X1 and ₹ XXX in 20X0, and the accumulated loss should be increased by ₹ XXX in 20X1 and Rs.XXX in 20X0.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

⁹ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

I.556 Auditing Pronouncements

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation ¹⁰)
Membership Number

Place of Signature

Date

Example B - Corresponding Figures (Ref: Para. A5)

Report illustrative of the circumstances described in paragraph 11(b), as follows:

- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are immaterial but require a modification to the auditor's opinion because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements ¹¹

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our

¹⁰ Partner or Proprietor, as the case may be.

¹¹ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹². An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

Because we were appointed auditors of the Company during 20X0, we were not able to observe the counting of the physical inventories at the beginning of that period or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 20X0. Our audit opinion on the financial statements for the year ended 31 March, 20X0 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

Qualified Opinion

In our opinion, except for the possible effects on the corresponding figures of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹³)
Membership Number

Place of Signature

Date

¹² The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

¹³ Partner or Proprietor, as the case may be.

Example C - Corresponding Figures (Ref: Para. A7)

Report illustrative of the circumstances described in paragraph 13, as follows

- The prior period's financial statements were audited by a predecessor auditor.
- The auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements¹⁴

We have audited the accompanying financial statements of ABC Company Ltd. ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹⁵. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

¹⁴ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁵ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 (“the Act”).

Other Matters

The financial statements of the Company for the year ended March 31, 20X1, were audited by another auditor who expressed an unmodified opinion on those statements on June 30, 20X1.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor’s report will vary depending on the nature of the auditor’s other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm’s Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁶)
Membership Number

Place of Signature

Date

Example D - Comparative Financial Statements (Ref: Para. A9)

Report illustrative of the circumstances described in paragraph 15, as follows:

- Auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year’s audit.
- The financial reporting framework used in preparing the financial statements is other than accounting principals generally accepted in India. However, the audit is performed in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India.
- The auditor’s report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period’s figures are material to both the current period financial statements and prior period financial statements and require a modification to the auditor’s opinion.

INDEPENDENT AUDITOR’S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements¹⁷

We have audited the accompanying financial statements of ABC Company Ltd. (“the Company”), which

¹⁶ Partner or Proprietor, as the case may be.

¹⁷ The sub-title “Report on the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

I.560 Auditing Pronouncements

comprise the balance sheets as at March 31, 20X1 and 20X0, and the statements of profit & loss, and cash flow statements for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹⁸. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by Rs.XXX in 20X1 and Rs.XXX in 20X0, property, plant and equipment should be reduced by accumulated depreciation of Rs.XXX in 20X1 and Rs.XXX in 20X0, and the accumulated loss should be increased by Rs.XXX in 20X1 and Rs.XXX in 20X0.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1 and 20X0 and of its results of operations and its cash flows for the years then ended in

¹⁸ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁹)
Membership Number

Place of Signature

Date

¹⁹ Partner or Proprietor, as the case may be.

SA 720*

**The Auditor's Responsibility in Relation to Other
Information in Documents Containing Audited
Financial Statements**
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. (Ref: Para. A1)
2. In this SA "documents containing audited financial statements" refers to annual reports (or similar documents), that are issued to owners (or similar stakeholders), containing audited financial statements and the auditor's report thereon. This SA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements. (Ref: Para. A2-A4)

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

4. The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report.

Definitions

5. For purposes of the SAs the following terms have the meanings attributed below:
 - (a) Other information – Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.
 - (b) Inconsistency – Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.
 - (c) Misstatement of fact – Other information that is unrelated to matters appearing in the audited financial

* Published in April, 2009 issue of the Journal.

statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Requirements

Reading Other Information

6. The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

7. The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. If it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable. (Ref: Para. A5)

Material Inconsistencies

8. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report

9. When revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in accordance with SA 705.¹

10. When revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance; and

(a) Include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with SA 706²; or

(b) Where withdrawal is legally permitted, withdraw from the engagement. (Ref: Para. A6- A7)

Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report

11. When revision of the audited financial statements is necessary, the auditor shall follow the relevant requirements in SA 560.³

12. When revision of the other information is necessary and management agrees to make the revision, the auditor shall carry out the procedures necessary under the circumstances. (Ref: Para. A8)

13. When revision of the other information is necessary, but management refuses to make the revision, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. (Ref: Para. A9)

Material Misstatements of Fact

14. If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. (Ref: Para. A10)

15. When, following such discussions, the auditor still considers that there is an apparent material

¹ SA 705, "Modifications to the opinion in the Independent Auditor's Report".

² SA 706, "Emphasis of Matter paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

³ SA 560, "Subsequent Events", paragraphs 10-17.

I.564 Auditing Pronouncements

misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's legal counsel, and the auditor shall consider the advice received.

16. When the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. (Ref: Para. A11)

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1-2)

A1. The auditor may have additional responsibilities, through statutory or other regulatory requirements, in relation to other information that are beyond the scope of this SA. For example, certain statutory and regulatory requirements may require the auditor to apply specific procedures to certain of the other information such as required supplementary data or to express an opinion on the reliability of performance indicators described in the other information. When there are such obligations, the auditor's additional responsibilities are determined by the nature of the engagement and by law, regulation and professional standards. If such other information is omitted or contains deficiencies, the auditor may be required by law or regulation to refer to the matter in the auditor's report.

A2. Other information may comprise, for example:

- A report by management or those charged with governance on operations.
- Financial summaries or highlights.
- Planned capital expenditures.
- Financial ratios.
- Selected quarterly data.

A3. For purposes of the SAs, other information does not encompass, for example:

- A press release or a transmittal memorandum, such as a covering letter, accompanying the document containing audited financial statements and the auditor's report thereon.
- Information contained in analyst briefings.
- Information contained on the entity's web site.

Considerations Specific to Smaller Entities (Ref: Para. 2)

A4. Unless required by law or regulation, smaller entities are less likely to issue documents containing audited financial statements. However, an example of such a document would be where a legal requirement exists for an accompanying report by those charged with governance.

Reading Other Information (Ref: Para. 7)

A5. Obtaining the other information prior to the date of the auditor's report enables the auditor to resolve possible material inconsistencies and apparent material misstatements of fact with management on a timely basis. An agreement with management as to when the other information will be available may be helpful.

Material Inconsistencies

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report (Ref: Para. 10)

A6. When management refuses to revise the other information, the auditor may base any decision on what further action to take on advice from the auditor's legal counsel.

A7. In case of certain entities such as, Central/State governments and related government entities (for

example, agencies, boards, commissions), withdrawal from the engagement may not be an option. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency.

Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report (Ref: Para. 12-13)

A8. When management agrees to revise the other information, the auditor's procedures may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon, and the other information are informed of the revision.

A9. When management refuses to make the revision of such other information that the auditor concludes is necessary, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Material Misstatements of Fact (Ref: Para. 14-16)

A10. When discussing an apparent material misstatement of fact with management, the auditor may not be able to evaluate the validity of some disclosures included within the other information and management's responses to the auditor's inquiries, and may conclude that valid differences of judgment or opinion exist.

A11. When the auditor concludes that there is a material misstatement of fact that management refuses to correct, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Material Modifications vis a vis ISA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements"

Deletions

1. Paragraph 10 of ISA 720 dealt with the circumstances where the revision of the financial statements is necessary and management refuses to make the revision. In these circumstances, the auditor shall communicate this matter to those charged with governance and include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706; or withhold the auditor's report; or where withdrawal is legally permitted, withdraw from the engagement. Since in India, the practice of withholding the auditor's report is not in vogue, an option of withholding the auditor's report by the auditor has been deleted. Similarly in paragraph A7 of the Application Section, an option of withholding the auditor's report by the auditor has been deleted.

2. Paragraph A2 of ISA 720 provides the examples of the other information including 'employment data' and 'names of officers and directors'. Reference to these two specific examples has been deleted so that the auditor can focus on more relevant aspects of other information.

3. Paragraph A4 of ISA 720 provides an example of the other information that may be included in a document containing the audited financial statements of a smaller entity are a detailed income statement and a management report..Since, in India, the terminology of "detailed income statement" and a "management report" do not exist; these have been deleted completely from the SA.

4. Paragraph A7 of ISA 720 provides that in case of public sector entities, withdrawal from the engagement or withholding the auditor's report may not be the options. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that withdrawal from the engagement may not be an option even in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Paragraph A7 has, accordingly, been made more generic in its application.

SA 800*

**Special Considerations—Audits of Financial
Statements Prepared in Accordance with Special
Purpose Frameworks**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2011)*

Introduction

Scope of this SA

1. The Standards on Auditing (SAs) in the 100-700 series apply to an audit of financial statements. This SA deals with special considerations in the application of those SAs to an audit of financial statements prepared in accordance with a special purpose framework.
2. This SA is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework. SA 805¹, deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement.
3. This SA does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objective

5. The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:
 - (a) The acceptance of the engagement;
 - (b) The planning and performance of that engagement; and
 - (c) Forming an opinion and reporting on the financial statements.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Special purpose financial statements – Financial statements prepared in accordance with a special purpose framework. (Ref: Para. A4)
 - (b) Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation

* Published in April, 2010 issue of the Journal.

¹ SA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement".

framework or a compliance framework². (Ref: Para. A1-A4)

7. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements.

Requirements

Considerations When Accepting the Engagement

Acceptability of the Financial Reporting Framework

8. SA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements³. In an audit of special purpose financial statements, the auditor shall obtain an understanding of: (Ref: Para. A5-A8)

- (a) The purpose for which the financial statements are prepared;
- (b) The intended users; and
- (c) The steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

Considerations When Planning and Performing the Audit

9. SA 200 requires the auditor to comply with all SAs relevant to the audit⁴. In planning and performing an audit of special purpose financial statements, the auditor shall determine whether application of the SAs requires special consideration in the circumstances of the engagement. (Ref: Para. A9-A12)

10. SA 315 requires the auditor to obtain an understanding of the entity's selection and application of accounting policies⁵. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the information presented in the financial statements.

Forming an Opinion and Reporting Considerations

11. When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in SA 700 (Revised)⁶. (Ref: Para. A13)

Description of the Applicable Financial Reporting Framework

12. SA 700 (Revised) requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework⁷. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

13. SA 700 (Revised) deals with the form and content of the auditor's report. In the case of an auditor's

² SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 13(a).

³ SA 210, "Agreeing the Terms of Audit Engagements", paragraph 6 (a).

⁴ SA 200, paragraph 18.

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11(c).

⁶ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

⁷ SA 700 (Revised), paragraph 15.

report on special purpose financial statements:

- (a) The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information; and
- (b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework

14. The auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. The auditor shall include this paragraph under an appropriate heading. (Ref: Para. A14-A15)

Application and Other Explanatory Material

Special Purpose Frameworks⁸ (Ref: Para. 6)

A1. Examples of special purpose frameworks are:

- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors;
- The financial reporting provisions established by a regulator to meet the requirements of that regulator; or
- The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant.

A2. There may be circumstances where a special purpose framework is based on a financial reporting framework established by an authorised or recognised standards setting organization or by law or regulation, but does not comply with all the requirements of that framework. An example is a contract that requires financial statements to be prepared in accordance with most, but not all, of the Financial Reporting Standards of Jurisdiction X. When this is acceptable in the circumstances of the engagement, it is inappropriate for the description of the applicable financial reporting framework in the special purpose financial statements to imply full compliance with the financial reporting framework established by the authorised or recognized standards setting organization or by law or regulation. In the above example of the contract, the description of the applicable financial reporting framework may refer to the financial reporting provisions of the contract, rather than make any reference to the Financial Reporting Standards of Jurisdiction X.

A3. In the circumstances described in paragraph A2, the special purpose framework may not be a fair presentation framework even if the financial reporting framework on which it is based is a fair presentation framework. This is because the special purpose framework may not comply with all the requirements of the financial reporting framework established by the authorized or recognized standards setting organization

⁸ In India, financial statements prepared for filing with income tax authorities are considered to be general purpose financial statements. Attention of the readers are also invited to the announcement published in "The Chartered Accountant", August 1994 (page 224) which states that: "It is hereby clarified that the mandatory accounting standards also apply in respect of financial statements audited under section 44AB of the Income Tax Act, 1961. Accordingly, members should examine compliance with the mandatory accounting standards when conducting such audit".

or by law or regulation that are necessary to achieve fair presentation of the financial statements.

A4. Financial statements prepared in accordance with a special purpose framework may be the only financial statements an entity prepares. In such circumstances, those financial statements may be used by users other than those for whom the financial reporting framework is designed. Despite the broad distribution of the financial statements in those circumstances, the financial statements are still considered to be special purpose financial statements for purposes of the SAs. The requirements in paragraphs 13-14 are designed to avoid misunderstandings about the purpose for which the financial statements are prepared.

Considerations When Accepting the Engagement

Acceptability of the Financial Reporting Framework (Ref: Para. 8)

A5. In the case of special purpose financial statements, the financial information needs of the intended users are a key factor in determining the acceptability of the financial reporting framework applied in the preparation of the financial statements.

A6. The applicable financial reporting framework may encompass the financial reporting standards established by an organization that is authorized or recognized to promulgate standards for special purpose financial statements. In that case, those standards will be presumed acceptable for that purpose if the organization follows an established and transparent process involving deliberation and consideration of the views of relevant stakeholders. Some law(s) or regulation(s) may prescribe the financial reporting framework to be used by management in the preparation of special purpose financial statements for a certain type of entity. For example, a regulator may establish financial reporting provisions to meet the requirements of that regulator. In the absence of indications to the contrary, such a financial reporting framework is presumed acceptable for special purpose financial statements prepared by such entity.

A7. Where the financial reporting standards referred to in paragraph A6 are supplemented by legislative or regulatory requirements, SA 210 requires the auditor to determine whether any conflicts between the financial reporting standards and the additional requirements exist, and prescribes actions to be taken by the auditor if such conflicts exist⁹.

A8. The applicable financial reporting framework may encompass the financial reporting provisions of a contract, or sources other than those described in paragraphs A6 and A7. In that case, the acceptability of the financial reporting framework in the circumstances of the engagement is determined by considering whether the framework exhibits attributes normally exhibited by acceptable financial reporting frameworks as described in Appendix 2 of SA 210. In the case of a special purpose framework, the relative importance to a particular engagement of each of the attributes normally exhibited by acceptable financial reporting frameworks is a matter of professional judgment. For example, for purposes of establishing the value of net assets of an entity at the date of its sale, the vendor and the purchaser may have agreed that very prudent estimates of allowances for uncollectible accounts receivable are appropriate for their needs, even though such financial information is not neutral when compared with financial information prepared in accordance with a general purpose framework.

Considerations When Planning and Performing the Audit (Ref: Para. 9)

A9. SA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all SAs relevant to the audit. It also requires the auditor to comply with each requirement of an SA unless, in the circumstances of the audit, the entire SA is not relevant or the requirement is not relevant because it is conditional and the

⁹ SA 210, paragraph 18.

I.570 Auditing Pronouncements

condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement¹⁰.

A10. Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in SA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group¹¹. In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

A11. In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with SA 320 for purposes of planning and performing the audit of the special purpose financial statements.

A12. Communication with those charged with governance in accordance with SAs is based on the relationship between those charged with governance and the financial statements subject to audit, in particular, whether those charged with governance are responsible for overseeing the preparation of those financial statements. In the case of special purpose financial statements, those charged with governance may not have such a responsibility; for example, when the financial information is prepared solely for management's use. In such cases, the requirements of SA 260¹² may not be relevant to the audit of the special purpose financial statements, except when the auditor is also responsible for the audit of the entity's general purpose financial statements or, for example, has agreed with those charged with governance of the entity to communicate to them relevant matters identified during the audit of the special purpose financial statements.

Forming an Opinion and Reporting Considerations (Ref: Para. 11)

A13. The Appendix to this SA contains illustrations of auditors' reports on special purpose financial statements.

Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework (Ref: Para. 14)

A14. The special purpose financial statements may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose financial statements on public record. To avoid misunderstandings, the auditor alerts users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose.

Restriction on Distribution or Use (Ref: Para. 14)

A15. In addition to the alert required by paragraph 14, the auditor may consider it appropriate to indicate that the auditor's report is intended solely for the specific users. Depending on the law or regulation of the particular jurisdiction, this may be achieved by restricting the distribution or use of the auditor's report. In these circumstances, the paragraph referred to in paragraph 14 may be expanded to include these other matters, and the heading modified accordingly.

¹⁰ SA 200, paragraphs 14, 18 and 22-23.

¹¹ SA 320, "Materiality in Planning and Performing an Audit", paragraph 2.

¹² SA 260, "Communication with Those Charged with Governance".

Modifications vis-a-vis ISA 800, “Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks”**Deletion**

Paragraph A1 of ISA 800 deals with the examples of special purpose frameworks, which also includes a tax basis of accounting for a set of financial statements that accompany an entity’s tax return. Since in India, financial statements prepared for filing with income tax authorities are considered to be general purpose financial statements and as per the announcement issued under the authority of the Council of the Institute of Chartered Accountants of India (ICAI) in August, 1994, the mandatory accounting standards should also be applied in respect of financial statements audited under section 44AB of the Income Tax Act, 1961, an example, “A tax basis of accounting for a set of financial statements that accompany an entity’s tax return” has been deleted.

Appendix

(Ref: Para. A13)

Illustrations of Auditors’ Reports on Special Purpose Financial Statements

Illustration 1: An auditor’s report on a complete set of financial statements prepared in accordance with the financial reporting provisions of a contract (for purposes of this illustration, a compliance framework).

Illustration 2: An auditor’s report on a complete set of financial statements prepared in accordance with the financial reporting provisions established by a regulator (for purposes of this illustration, a fair presentation framework).

Illustration 1:

Circumstances include the following:

- **The financial statements have been prepared by management of the entity in accordance with the financial reporting provisions of a contract (i.e., a special purpose framework) to comply with the provisions of that contract. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a compliance framework.**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.**
- **Distribution and use of the auditor’s report are restricted.**

INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

We have audited the accompanying financial statements of ABC Company Ltd., which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management of ABC Company Ltd. based on the financial reporting provisions of section/ clause Z of the contract dated July 1, 20X0 between ABC Company Ltd. and DEF Company Ltd. (“the contract”).

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the financial reporting provisions of section/ clause Z of the contract; this includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from

I.572 Auditing Pronouncements

material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹³. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements of ABC Company Ltd. for the year ended March 31, 20X1 are prepared, in all material respects, in accordance with the financial reporting provisions of section/ clause Z of the contract.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist ABC Company Ltd. to comply with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for ABC Company Ltd. and DEF Company Ltd. and should not be distributed to or used by parties other than ABC Company Ltd. or DEF Company Ltd.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁴)
Membership Number

Place of Signature

Date

¹³ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

¹⁴ Partner or Proprietor, as the case may be.

Illustration 2:

Circumstances include the following:

- The financial statements have been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator (i.e., a special purpose framework) to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a fair presentation framework.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- Distribution or use of the auditor's report is not restricted.
- The Other Matter paragraph refers to the fact that the auditor has also issued an auditor's report on financial statements prepared by ABC Company Ltd. for the same period in accordance with a general purpose framework.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying financial statements of ABC Company Ltd., which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management based on the financial reporting provisions of Section Y of Regulation Z.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the financial reporting provisions of Section Y of Regulation Z; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹⁵. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall

¹⁵ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

I.574 Auditing Pronouncements

presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view of the state of affairs of ABC Company Ltd. as at March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the financial reporting provisions of Section Y of Regulation Z.

Basis of Accounting

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist ABC Company Ltd. to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose.

Other Matter

ABC Company Ltd. has prepared a separate set of financial statements for the year ended March 31, 20X1 in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") on which we issued a separate auditor's report to the shareholders of ABC Company Ltd. dated June 30, 20X1.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁶)
Membership Number

Place of Signature

Date

¹⁶ Partner or Proprietor, as the case may be.

SA 805*

**Special Considerations—Audits of Single
Financial Statements and Specific Elements,
Accounts or Items of a Financial Statement**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2011)*

Introduction

Scope of this SA

1. The Standards on Auditing (SAs) in the 100-700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800¹ also applies to the audit. (Ref: Para. A1-A4)
2. This SA does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements (see Proposed Revised SA 600²).
3. This SA does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

Effective Date

4. This SA is effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after April 1, 2011. In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement prepared as at a specific date, this SA is effective for audits of such information prepared as at a date on or after April 1, 2011.

Objective

5. The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:
 - (a) The acceptance of the engagement;
 - (b) The planning and performance of that engagement; and

* Published in the April, 2010 issue of the Journal.

¹ SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks".

² Currently, SA 600, 'Using the Work of Another Auditor' is in force. The standard is being revised in light of the corresponding international standard.

I.576 Auditing Pronouncements

- (c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

Definitions

6. For purposes of this SA, reference to:

- (a) "Element of a financial statement" or "element" means an "element, account or item of a financial statement";
- (b) "Financial Reporting Standards" means the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India, as may be applicable; and
- (c) A single financial statement (for example, a cash flow statement) or to a specific element of a financial statement (for example, cash and bank balances) includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

Requirements

Considerations When Accepting the Engagement

Application of SAs

7. SA 200 requires the auditor to comply with all SAs relevant to the audit³. In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements. If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with SAs is practicable. (Ref: Para. A5-A6)

Acceptability of the Financial Reporting Framework

8. SA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements⁴. In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element. (Ref: Para. A7)

Form of Opinion

9. SA 210 requires that the agreed terms of the audit engagement include the expected form of any reports to be issued by the auditor⁵. In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances. (Ref: Para. A8-A9)

³ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 18.

⁴ SA 210, "Agreeing the Terms of Audit Engagements", paragraph 6(a).

⁵ SA 210, paragraph 10(e).

Considerations When Planning and Performing the Audit

10. SA 200 states that SAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.^{6 7} In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all SAs relevant to the audit as necessary in the circumstances of the engagement. (Ref: Para. A10-A14)

Forming an Opinion and Reporting Considerations

11. When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in SA 700 (Revised)⁸, adapted as necessary in the circumstances of the engagement. (Ref: Para. A15-A16)

Reporting on the Entity's Complete Set of Financial Statements and on a Single Financial Statement or on a Specific Element of Those Financial Statements

12. If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

13. An audited single financial statement or an audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements. If the auditor concludes that the presentation of the single financial statement or of the specific element of a financial statement does not differentiate it sufficiently from the complete set of financial statements, the auditor shall ask management to rectify the situation. Subject to paragraphs 15 and 16, the auditor shall also differentiate the opinion on the single financial statement or on the specific element of a financial statement from the opinion on the complete set of financial statements. The auditor shall not issue the auditor's report containing the opinion on the single financial statement or on the specific element of a financial statement until satisfied with the differentiation.

Modified Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Entity's Complete Set of Financial Statements

14. If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an Emphasis of Matter paragraph or an Other Matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements. When deemed appropriate, the auditor shall modify the opinion on the single financial statement or on the specific element of a financial statement, or include an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report, accordingly. (Ref: Para. A17)

15. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, SA 705 does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element that forms part of those financial statements⁹. This is because such an unmodified opinion would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole. (Ref: Para. A18)

16. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the

⁶ SA 200, paragraph 2.

⁷ SA 200, paragraph 13(f), explains that the term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework.

⁸ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

⁹ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 15.

I.578 Auditing Pronouncements

entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element that is included in those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:

- (a) The auditor is not prohibited by law or regulation from doing so;
- (b) That opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and
- (c) The specific element does not constitute a major portion of the entity's complete set of financial statements.

17. The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole. This is the case even if the auditor's report on the single financial statement is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion. This is because a single financial statement is deemed to constitute a major portion of those financial statements.

Application and Other Explanatory Material

Scope of this SA (Ref. Para. 1)

A1. SA 200 defines the term "historical financial information" as information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past¹⁰.

A2. SA 200 defines the term "financial statements" as a structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework¹¹.

A3. SAs are written in the context of an audit of financial statements¹²; they are to be adapted as necessary in the circumstances when applied to an audit of other historical financial information, such as a single financial statement or a specific element of a financial statement. This SA assists in this regard. (Appendix 1 lists examples of such other historical financial information.)

A4. A reasonable assurance engagement other than an audit of historical financial information is performed in accordance with Proposed Standard on Assurance Engagements (SAE) 3000¹³.

Considerations When Accepting the Engagement

Application of SAs (Ref. Para. 7)

A5. SA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all SAs relevant to the audit. It also requires the auditor to comply with each requirement of an SA unless, in the circumstances of the audit, the entire SA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant

¹⁰ SA 200, paragraph 13(g).

¹¹ SA 200, paragraph 13(f).

¹² SA 200, paragraph 2.

¹³ The Exposure Draft of SAE 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information" has been published in the March, 2010 issue of the Journal.

requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement¹⁴.

A6. Compliance with the requirements of SAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have the audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records. In the case of an audit of a specific element of a financial statement, certain SAs require audit work that may be disproportionate to the element being audited. For example, although the requirements of SA 570¹⁵ are likely to be relevant in the circumstances of an audit of a schedule of accounts receivable, complying with those requirements may not be practicable because of the audit effort required. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with SAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

Acceptability of the Financial Reporting Framework (Ref: Para. 8)

A7. A single financial statement or a specific element of a financial statement may be prepared in accordance with an applicable financial reporting framework that is based on a financial reporting framework established by an authorised or recognised standards setting organisation for the preparation of a complete set of financial statements (e.g., Financial Reporting Standards). If this is the case, determination of the acceptability of the applicable framework may involve considering whether that framework includes all the requirements of the framework on which it is based that are relevant to the presentation of a single financial statement or of a specific element of a financial statement that provides adequate disclosures.

Form of Opinion (Ref: Para. 9)

A8. The form of opinion to be expressed by the auditor depends on the applicable financial reporting framework and any applicable laws or regulations¹⁶. In accordance with SA 700 (Revised)¹⁷:

- (a) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion, unless otherwise required by law or regulation, uses one of the following phrases: (i) the financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework]; or (ii) the financial statements give a true and fair view in accordance with [the applicable financial reporting framework]; and
- (b) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a compliance framework, the auditor's opinion states that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

A9. In the case of a single financial statement or of a specific element of a financial statement, the applicable financial reporting framework may not explicitly address the presentation of the financial statement or of the element. This may be the case when the applicable financial reporting framework is based on a financial reporting framework established by an authorised or recognised standards setting organization for the preparation of a complete set of financial statements (e.g., Financial Reporting Standards). The auditor

¹⁴ SA 200, paragraphs 14, 18 and 22-23.

¹⁵ SA 570, "Going Concern".

¹⁶ SA 200, paragraph 8.

¹⁷ SA 700 (Revised), paragraphs 35-36.

I.580 Auditing Pronouncements

therefore considers whether the expected form of opinion is appropriate in the light of the applicable financial reporting framework. Factors that may affect the auditor's consideration as to whether to use the phrases "presents fairly, in all material respects", or "gives a true and fair view" in the auditor's opinion include:

- Whether the applicable financial reporting framework is explicitly or implicitly restricted to the preparation of a complete set of financial statements.
- Whether the single financial statement or the specific element of a financial statement will:
 - ◆ Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the financial statement or the element include the related notes.
 - ◆ If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework.

The auditor's decision as to the expected form of opinion is a matter of professional judgment. It may be affected by whether use of the phrases "presents fairly, in all material respects", or "gives a true and fair view" in the auditor's opinion on a single financial statement or on a specific element of a financial statement prepared in accordance with a fair presentation framework is generally accepted in the particular jurisdiction.

Considerations When Planning and Performing the Audit (Ref: Para. 10)

A10. The relevance of each of the SAs requires careful consideration. Even when only a specific element of a financial statement is the subject of the audit, SAs such as SA 240¹⁸, SA 550¹⁹ and SA 570 are, in principle, relevant. This is because the element could be misstated as a result of fraud, the effect of related party transactions, or the incorrect application of the going concern assumption under the applicable financial reporting framework.

A11. Furthermore, SAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to the audit of a single financial statement or of a specific element of a financial statement²⁰. For example, written representations from management about the complete set of financial statements would be replaced by written representations about the presentation of the financial statement or the element in accordance with the applicable financial reporting framework.

A12. When auditing a single financial statement or a specific element of a financial statement in conjunction with the audit of the entity's complete set of financial statements, the auditor may be able to use audit evidence obtained as part of the audit of the entity's complete set of financial statements in the audit of the financial statement or the element. SAs, however, require the auditor to plan and perform the audit of the financial statement or element to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statement or on the element.

A13. The individual financial statements that comprise a complete set of financial statements, and many of the elements of those financial statements, including their related notes, are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the financial statement or the element in isolation. Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit.

A14. Furthermore, the materiality determined for a single financial statement or for a specific element of a financial statement may be lower than the materiality determined for the entity's complete set of financial statements; this will affect the nature, timing and extent of the audit procedures and the evaluation of

¹⁸ SA 240, 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements'.

¹⁹ SA 550, "Related Parties".

²⁰ SA 200, paragraph 2.

uncorrected misstatements.

Forming an Opinion and Reporting Considerations (Ref: Para. 11, 14)

A15. SA 700 (Revised) requires the auditor, in forming an opinion, to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements²¹. In the case of a single financial statement or of a specific element of a financial statement, it is important that the financial statement or the element, including the related notes, in view of the requirements of the applicable financial reporting framework, provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element.

A16. Appendix 2 of this SA contains illustrations of auditors' reports on a single financial statement and on a specific element of a financial statement.

Modified Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Entity's Complete Set of Financial Statements (Ref: Para. 14-15)

A17. Even when the modified opinion on the entity's complete set of financial statements, Emphasis of Matter paragraph or Other Matter paragraph does not relate to the audited financial statement or the audited element, the auditor may still deem it appropriate to refer to the modification in an Other Matter paragraph in an auditor's report on the financial statement or on the element because the auditor judges it to be relevant to the users' understanding of the audited financial statement or the audited element or the related auditor's report (see SA 706)²².

A18. In the auditor's report on an entity's complete set of financial statements, the expression of a disclaimer of opinion regarding the results of operations and cash flows, where relevant, and an unmodified opinion regarding the state of affairs is permitted since the disclaimer of opinion is being issued in respect of the results of operations and cash flows only and not in respect of the financial statements as a whole²³.

Modifications *vis-a-vis* ISA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement"

Addition

Paragraph 6(b) of ISA 805 defines the meaning of the International Financial Reporting Standards (IFRS). Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be 'Accounting Standards issued by the Institute of Chartered Accountants of India or Accounting Standards, notified by the Central Government by publishing the same as Companies (Accounting Standards) Rules, 2006' or 'Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI)', the paragraph 6(b) has, accordingly, been changed. Corresponding changes have also been made at the relevant places of the Standard.

²¹ SA 700 (Revised), paragraph 13(e).

²² SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 6.

²³ SA 510, "Initial Audit Engagements—Opening Balances", paragraph A5, and SA 705, paragraph A16.

Appendix 1

(Ref: Para. A3)

Examples of Specific Elements, Accounts or Items of a Financial Statement

- Accounts receivable, allowance for doubtful accounts receivable, inventory, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for “incurred but not reported” claims in an insurance portfolio, including related notes.
- A schedule of externally managed assets and income of a private pension plan, including related notes.
- A schedule of net tangible assets, including related notes.
- A schedule of disbursements in relation to a lease property, including explanatory notes.
- A schedule of profit participation or employee bonuses, including explanatory notes.

Appendix 2

(Ref: Para. A16)

Illustrations of Auditors’ Reports on a Single Financial Statement and on a Specific Element of a Financial Statement

- Illustration 1: An auditor’s report on a single financial statement prepared in accordance with a general purpose framework (for purposes of this illustration, a fair presentation framework).
- Illustration 2: An auditor’s report on a single financial statement prepared in accordance with a special purpose framework (for purposes of this illustration, a fair presentation framework).
- Illustration 3: An auditor’s report on a specific element, account or item of a financial statement prepared in accordance with a special purpose framework (for purposes of this illustration, a compliance framework).

Illustration 1:

Circumstances include the following:

- **Audit of a balance sheet (i.e., a single financial statement).**
- **The balance sheet has been prepared by management of the entity in accordance with the requirements of the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 (“the Act”) relevant to preparing a balance sheet.**
- **The applicable financial reporting framework is a fair presentation framework designed to meet the common financial information needs of a wide range of users.**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.**
- **The auditor has determined that it is appropriate to use the phrase “presents a true and fair view”, in the auditor’s opinion.**

INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

We have audited the accompanying balance sheet of ABC Company Ltd. as at March 31, 20X1 and a summary of significant accounting policies and other explanatory information (together “the financial statement”).

Management's²⁴ Responsibility for the Financial Statement

Management is responsible for the preparation and fair presentation of this financial statement in accordance with the requirements of the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"), relevant to preparing such a financial statement. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statement that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the financial statement based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control²⁵. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, made by management, as well as evaluating the overall presentation of the financial statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statement presents a true and fair view of the state of affairs of ABC Company Ltd. as at March 31, 20X1 in accordance with those requirements of the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"), relevant to preparing such a financial statement.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation²⁶)
Membership Number

Place of Signature

Date

²⁴ Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

²⁵ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

²⁶ Partner or Proprietor, as the case may be.

Illustration 2:

Circumstances include the following:

- **Audit of a statement of cash receipts and disbursements (i.e., a single financial statement).**
- **The financial statement has been prepared by management of the entity in accordance with the cash receipts and disbursements basis of accounting to respond to a request for cash flow information received from a creditor. Management has a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a fair presentation framework designed to meet the financial information needs of specific users²⁷.**
- **The auditor has determined that it is appropriate to use the phrase “true and fair view” in the auditor’s opinion.**
- **Distribution or use of the auditor’s report is not restricted.**

INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

We have audited the accompanying statement of cash receipts and disbursements of ABC Company Ltd. for the year ended March 31, 20X1 and a summary of significant accounting policies and other explanatory information (together “the financial statement”). The financial statement has been prepared by management using the cash receipts and disbursements basis of accounting described in Note X.

Management’s²⁸ Responsibility for the Financial Statement

Management is responsible for the preparation and fair presentation of this financial statement in accordance with the cash receipts and disbursements basis of accounting described in Note X; this includes determining that the cash receipts and disbursements basis of accounting is an acceptable basis for the preparation of the financial statement in the circumstances, and the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statement that is free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express an opinion on the financial statement based on our audit. We conducted our audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statement. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control²⁹. An audit also includes evaluating the appropriateness of accounting policies used and the

²⁷ SA 800 contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

²⁸ Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

²⁹ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph ‘C’, “Announcements/Clarifications” of Section 1, “Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India”, included in Volume I.A of the Handbook.

reasonableness of accounting estimates, if any, made by management, as well as evaluating the overall presentation of the financial statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statement presents a true and fair view of the cash receipts and disbursements of ABC Company Ltd. for the year ended March 31, 20X1 in accordance with the cash receipts and disbursements basis of accounting described in Note X.

Basis of Accounting

Without modifying our opinion, we draw attention to Note X to the financial statement, which describes the basis of accounting. The financial statement is prepared to provide information to XYZ Creditor. As a result, the statement may not be suitable for another purpose.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation³⁰)
Membership Number

Place of Signature

Date

Illustration 3:

Circumstances include the following:

- **Audit of the liability for “incurred but not reported” claims in an insurance portfolio (i.e., element, account or item of a financial statement).**
- **The financial information has been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users³¹.**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.**
- **Distribution of the auditor’s report is restricted.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying schedule of the liability for “incurred but not reported” claims of ABC Insurance Company as of March 31, 20X1 (“the schedule”). The schedule has been prepared by management based on [describe the financial reporting provisions established by the regulator].

³⁰ Partner or Proprietor, as the case may be.

³¹ SA 800 contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

Management's³² Responsibility for the Schedule

Management is responsible for the preparation of the schedule in accordance with [describe the financial reporting provisions established by the regulator]; this includes the design, implementation and maintenance of internal control relevant to the preparation of the schedule that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the schedule based on our audit. We conducted our audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the schedule is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the schedule in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control³³. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the schedule.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial information in the schedule of the liability for "incurred but not reported" claims of ABC Insurance Company as of March 31, 20X1 is prepared, in all material respects, in accordance with [describe the financial reporting provisions established by the regulator].

Basis of Accounting and Restriction on Distribution

Without modifying our opinion, we draw attention to Note X to the schedule, which describes the basis of accounting. The schedule is prepared to assist ABC Insurance Company to meet the requirements of Regulator DEF. As a result, the schedule may not be suitable for another purpose. Our report is intended solely for ABC Insurance Company and Regulator DEF and should not be distributed to parties other than ABC Insurance Company or Regulator DEF.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation³⁴)
Membership Number

Place of Signature
Date

³² Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

³³ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

³⁴ Partner or Proprietor, as the case may be.

SA 810*

**Engagements to Report on Summary Financial
Statements**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2011)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.

Effective Date

2. This SA is effective for engagements for periods beginning on or after April 1, 2011.

Objectives

3. The objectives of the auditor are to:

- (a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;
- (b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and
- (c) Express clearly that opinion through a written report that also describes the basis for that opinion.

Definitions

4. For purposes of this SA, the following terms have the meanings attributed below:

- (a) Applied criteria – The criteria applied by management in the preparation of the summary financial statements.
- (b) Audited financial statements – Financial statements¹ audited by the auditor in accordance with SAs, and from which the summary financial statements are derived.
- (c) Summary financial statements – Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time². Different jurisdictions may use different terminology to describe such historical financial information.

* Published in April, 2010 issue of the Journal. Pursuant to issuance of SA 810, the 'Guidance Note on Audit of Abridged Financial Statements' issued in 1990 has been withdrawn.

¹ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 13(f).

² SA 200, paragraph 13(f).

Requirements

Engagement Acceptance

5. The auditor shall, ordinarily, accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the financial statements from which the summary financial statements are derived³. (Ref: Para. A1)
6. Before accepting an engagement to report on summary financial statements, the auditor shall: (Ref: Para. A2)
- (a) Determine whether the applied criteria are acceptable; (Ref: Para. A3-A7)
 - (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - i. For the preparation of the summary financial statements in accordance with the applied criteria;
 - ii. To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements); and
 - iii. To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.
 - (c) Agree with management the form of opinion to be expressed on the summary financial statements (see paragraphs 9-11).
7. If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management set out in paragraph 6(b), the auditor shall not accept the engagement to report on the summary financial statements, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this SA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA. The auditor shall include appropriate reference to this fact in the terms of the engagement. The auditor shall also determine the effect that this may have on the engagement to audit the financial statements from which the summary financial statements are derived.

Nature of Procedures

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

³ In some cases however the auditor may be required by a law or a regulation governing the entity to report on summary financial statements even for such accounting periods for which the former was not engaged to conduct the audit in accordance with SAs of the financial statements pertaining to such accounting periods. For example, in case of the report of the auditor of the company to be included in a prospectus under Clauses 1, 2, 3 of Part IIB of Schedule II to the Companies Act, 1956, such auditor might not necessarily have been the auditor of all or some of the financial statements of the company in respect of the accounting periods relating to which financial information has been reported upon by him/ her in the aforementioned report.

- (i) From whom or where the audited financial statements are available; or
 - (ii) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
- (c) Evaluate whether the summary financial statements adequately disclose the applied criteria.
 - (d) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be re-calculated from the related information in the audited financial statements.
 - (e) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.
 - (f) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
 - (g) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements. (Ref: Para. A8)

Form of Opinion

9. When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases: (Ref: Para. A9)

- (a) The summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with [the applied criteria]; or
- (b) The summary financial statements are a fair summary of the audited financial statements, in accordance with [the applied criteria].

10. If law or regulation prescribes the wording of the opinion on summary financial statements in terms that are different from those described in paragraph 9, the auditor shall:

- (a) Apply the procedures described in paragraph 8 and any further procedures necessary to enable the auditor to express the prescribed opinion; and
- (b) Evaluate whether users of the summary financial statements might misunderstand the auditor's opinion on the summary financial statements and, if so, whether additional explanation in the auditor's report on the summary financial statements can mitigate possible misunderstanding.

11. If, in the case of paragraph 10(b), the auditor concludes that additional explanation in the auditor's report on the summary financial statements cannot mitigate possible misunderstanding, the auditor shall not accept the engagement, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this SA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA.

Timing of Work and Events Subsequent to the Date of the Auditor's Report on the Audited Financial Statements

12. The auditor's report on the summary financial statements may be dated later than the date of the auditor's report on the audited financial statements. In such cases, the auditor's report on the summary

I.590 Auditing Pronouncements

financial statements shall state that the summary financial statements and audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements that may require adjustment of, or disclosure in, the audited financial statements. (Ref: Para. A10)

13. The auditor may become aware of facts that existed at the date of the auditor's report on the audited financial statements, but of which the auditor previously was unaware. In such cases, the auditor shall not issue the auditor's report on the summary financial statements until the auditor's consideration of such facts in relation to the audited financial statements in accordance with SA 560⁴ has been completed.

Auditor's Report on Summary Financial Statements

Elements of the Auditor's Report

14. The auditor's report on summary financial statements shall include the following elements⁵: (Ref: Para. A15)

- (a) A title clearly indicating it as the report of an independent auditor. (Ref: Para. A11)
- (b) An addressee. (Ref: Para. A12)
- (c) An introductory paragraph that:
 - (i) Identifies the summary financial statements on which the auditor is reporting, including the title of each statement included in the summary financial statements; (Ref: Para. A13)
 - (ii) Identifies the audited financial statements;
 - (iii) Refers to the auditor's report on the audited financial statements, the date of that report, and, subject to paragraphs 17-18, the fact that an unmodified opinion is expressed on the audited financial statements;
 - (iv) If the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, states that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements; and
 - (v) A statement indicating that the summary financial statements do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements, and that reading the summary financial statements is not a substitute for reading the audited financial statements.
- (d) A description of management's responsibility for the summary financial statements, explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria.
- (e) A statement that the auditor is responsible for expressing an opinion on the summary financial statements based on the procedures required by this SA.
- (f) A paragraph clearly expressing an opinion. (see paragraphs 9-11)
- (g) The auditor's signature along with the firm registration number, wherever applicable, and the membership number assigned by the Institute of Chartered Accountants of India (ICAI).
- (h) The date of the auditor's report. (Ref: Para. A14)

⁴ SA 560, "Subsequent Events".

⁵ Paragraphs 17-18, which deal with circumstances where the auditor's report on the audited financial statements has been modified, require additional elements to those listed in this paragraph.

(i) The place of signature.

15. If the addressee of the summary financial statements is not the same as the addressee of the auditor's report on the audited financial statements, the auditor shall evaluate the appropriateness of using a different addressee. (Ref: Para. A12)

16. The auditor shall date the auditor's report on the summary financial statements no earlier than: (Ref: Para. A14)

(a) The date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion, including evidence that the summary financial statements have been prepared and those with the recognised authority have asserted that they have taken responsibility for them; and

(b) The date of the auditor's report on the audited financial statements.

Modifications to the Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Audited Financial Statements (Ref: Para. A15)

17. When the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph, but the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall, in addition to the elements in paragraph 14:

(a) State that the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph; and

(b) Describe:

(i) The basis for the qualified opinion on the audited financial statements, and that qualified opinion; or the Emphasis of Matter or the Other Matter paragraph in the auditor's report on the audited financial statements; and

(ii) The effect thereof on the summary financial statements, if any.

18. When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall, in addition to the elements in paragraph 14:

(a) State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;

(b) Describe the basis for that adverse opinion or disclaimer of opinion; and

(c) State that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express an opinion on the summary financial statements.

Modified Opinion on the Summary Financial Statements

19. If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements. (Ref: Para. A15)

Restriction on Distribution or Use or Alerting Readers to the Basis of Accounting

20. When distribution or use of the auditor's report on the audited financial statements is restricted, or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework, the auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements.

Comparatives

21. If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement. The auditor shall determine the effect of an unreasonable omission on the auditor's report on the summary financial statements. (Ref: Para. A16)

22. If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that SA 710 requires the auditor to include in the auditor's report on the audited financial statements⁶. (Ref: Para. A17)

Unaudited Supplementary Information Presented with Summary Financial Statements

23. The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report. (Ref: Para. A18)

Other Information in Documents Containing Summary Financial Statements

24. The auditor shall read other information included in a document containing the summary financial statements and related auditor's report to identify material inconsistencies, if any, with the summary financial statements. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the summary financial statements or the other information needs to be revised. If, on reading the other information, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. (Ref: Para. A19)

Auditor Association

25. If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document. If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document. (Ref: Para. A20)

26. The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor shall be satisfied that:

- (a) The reference to the auditor is made in the context of the auditor's report on the audited financial statements; and
- (b) The statement does not give the impression that the auditor has reported on the summary financial statements.

If (a) or (b) are not met, the auditor shall request management to change the statement to meet them, or not to refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does

⁶ SA 710, "Comparative Information—Corresponding Figures and Comparative Financial Statements".

not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor shall advise management that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately referring to the auditor. (Ref: Para. A20)

Application and Other Explanatory Material

Engagement Acceptance (Ref: Para. 5-6)

A1. The audit of the financial statements from which the summary financial statements are derived provides the auditor with the necessary knowledge to discharge the auditor's responsibilities in relation to the summary financial statements in accordance with this SA. Application of this SA will not provide sufficient appropriate evidence on which to base the opinion on the summary financial statements if the auditor has not also audited the financial statements from which the summary financial statements are derived.

A2. Management's agreement with the matters described in paragraph 6 may be evidenced by its written acceptance of the terms of the engagement.

Criteria (Ref: Para. 6(a))

A3. Management is responsible for the determination of the information that needs to be reflected in the summary financial statements so that they are consistent, in all material respects, with or represent a fair summary of the audited financial statements. Because summary financial statements by their nature contain aggregated information and limited disclosure, there is an increased risk that they may not contain the information necessary so as not to be misleading in the circumstances. This risk increases when established criteria for the preparation of summary financial statements do not exist.

A4. Factors that may affect the auditor's determination of the acceptability of the applied criteria include:

- The nature of the entity;
- The purpose of the summary financial statements;
- The information needs of the intended users of the summary financial statements; and
- Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.

A5. The criteria for the preparation of summary financial statements may be established by an authorised or recognised standards setting organisation or by law or regulation. Similar to the case of financial statements, as explained in SA 210⁷, in many such cases, the auditor may presume that such criteria are acceptable.

A6. Where established criteria for the preparation of summary financial statements do not exist, criteria may be developed by management, for example, based on practice in a particular industry. Criteria that are acceptable in the circumstances will result in summary financial statements that:

- (a) Adequately disclose their summarised nature and identify the audited financial statements;
- (b) Clearly describe from whom or where the audited financial statements are available or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, that law or regulation;
- (c) Adequately disclose the applied criteria;
- (d) Agree with or can be re-calculated from the related information in the audited financial statements; and

⁷ SA 210, "Agreeing the Terms of Audit Engagements", paragraphs A3 and A8-A9.

I.594 Auditing Pronouncements

(e) In view of the purpose of the summary financial statements, contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.

A7. Adequate disclosure of the summarised nature of the summary financial statements and the identity of the audited financial statements, as referred to in paragraph A6(a), may, for example, be provided by a title such as “Summary Financial Statements Prepared from the Audited Financial Statements for the Year Ended March 31, 20X1”.

Evaluating the Availability of the Audited Financial Statements (Ref: Para. 8(g))

A8. The auditor’s evaluation whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty is affected by factors such as whether:

- The summary financial statements describe clearly from whom or where the audited financial statements are available;
- The audited financial statements are on public record; or
- Management has established a process by which the intended users of the summary financial statements can obtain ready access to the audited financial statements.

Form of Opinion (Ref: Para. 9)

A9. A conclusion, based on an evaluation of the evidence obtained by performing the procedures in paragraph 8, that an unmodified opinion on the summary financial statements is appropriate enables the auditor to express an opinion containing one of the phrases in paragraph 9. The auditor’s decision as to which of the phrases to use may be affected by generally accepted practice in the particular jurisdiction.

Timing of Work and Events Subsequent to the Date of the Auditor’s Report on the Audited Financial Statements (Ref: Para. 12)

A10. The procedures described in paragraph 8 are often performed during or immediately after the audit of the financial statements. When the auditor reports on the summary financial statements after the completion of the audit of the financial statements, the auditor is not required to obtain additional audit evidence on the audited financial statements, or report on the effects of events that occurred subsequent to the date of the auditor’s report on the audited financial statements since the summary financial statements are derived from the audited financial statements and do not update them.

Auditor’s Report on Summary Financial Statements

Elements of the Auditor’s Report

Title (Ref: Para. 14(a))

A11. A title indicating the report is the report of an independent auditor, for example, “Report of the Independent Auditor”, affirms that the auditor has met all of the relevant ethical requirements regarding independence. This distinguishes the report of the independent auditor from reports issued by others.

Addressee (Ref: Para. 14(b), 15)

A12. Factors that may affect the auditor’s evaluation of the appropriateness of the addressee of the summary financial statements include the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

Introductory Paragraph (Ref: Para. 14(c)(i))

A13. When the auditor is aware that the summary financial statements will be included in a document that contains other information, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the summary financial statements are presented. This helps readers to identify the

summary financial statements to which the auditor's report relates.

Date of the Auditor's Report (Ref: Para. 14(h), 16)

A14. The person or persons with recognised authority to conclude that the summary financial statements have been prepared and take responsibility for them depend on the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

Illustrations (Ref: Para. 14, 17-18, 19)

A15. The Appendix to this SA contains illustrations of auditors' reports on summary financial statements that:

- (a) Contain unmodified opinions;
- (b) Are derived from audited financial statements on which the auditor issued modified opinions; and
- (c) Contain a modified opinion.

Comparatives (Ref: Para. 21-22)

A16. If the audited financial statements contain comparatives, there is a presumption that the summary financial statements also would contain comparatives. Comparatives in the audited financial statements may be regarded as corresponding figures or as comparative financial information. SA 710 describes how this difference affects the auditor's report on the financial statements, including, in particular, reference to other auditors who audited the financial statements for the prior period.

A17. Circumstances that may affect the auditor's determination whether an omission of comparatives is reasonable include the nature and objective of the summary financial statements, the applied criteria, and the information needs of the intended users of the summary financial statements.

Unaudited Supplementary Information Presented with Summary Financial Statements (Ref: Para. 23)

A18. SA 700 (Revised)⁸ contains requirements and guidance to be applied when unaudited supplementary information is presented with audited financial statements that, adapted as necessary in the circumstances, may be helpful in applying the requirement in paragraph 23.

Other Information in Documents Containing Summary Financial Statements (Ref: Para. 24)

A19. SA 720⁹ contains requirements and guidance relating to reading other information included in a document containing the audited financial statements and related auditor's report, and responding to material inconsistencies and material misstatements of fact. Adapted as necessary in the circumstances, they may be helpful in applying the requirement in paragraph 24.

Auditor Association (Ref: Para. 25-26)

A20. Other appropriate actions the auditor may take when management does not take the requested action may include informing the intended users and other known third-party users of the inappropriate reference to the auditor. The auditor's course of action depends on the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

Material Modifications vis-a-vis ISA 810, "Engagements to Report on Summary Financial Statements"

Additions

1. Paragraph 5 of ISA 810 requires the auditor to accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in

⁸ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraphs 46-47.

⁹ SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".

accordance with SAs of the financial statements from which the summary financial statements are derived. In India, in some cases, the auditor may be required by a law or a regulation governing the entity to report on summary financial statements even for such accounting periods for which the former was not engaged to conduct the audit in accordance with SAs of the financial statements pertaining to such accounting periods. For example, in case of the report of the auditor of the company to be included in a prospectus under Clauses 1, 2, 3 of Part IIB of Schedule II to the Companies Act, 1956, such auditor might not necessarily have been the auditor of all or some of the financial statements of the company in respect of the accounting periods relating to which financial information has been reported upon by him/ her in the aforementioned report, accordingly, the word “ordinarily” has been added in the Paragraph 5 to cover these situations and also added the correspondingly footnote no. 5.

2. Paragraph 14 of ISA 810 deals with the elements of the summary financial statements that also include the auditor’s address. Since the Revised SA 700, “Forming an Opinion and Reporting on Financial Statements” requires the auditor to mention the “Place of Signature” instead of the “Auditor’s Address” in the auditor’s report, the requirement of mentioning the auditor’s address has been replaced with the place of signature.

3. Paragraph 14 of ISA 810 deals with the elements of the summary financial statements that also include auditor’s signature. Since as per the Revised SA 700, “Forming an Opinion and Reporting on Financial Statements”, the partner/proprietor signing the audit report also needs to mention the firm registration number, wherever applicable, and the membership number assigned by the Institute of Chartered Accountants of India, the said requirement has also been incorporated in the paragraph 14(g) of SA 810.

Appendix

(Ref: Para. A15)

Illustrations of Reports on Summary Financial Statements

- Illustration 1: An auditor’s report on summary financial statements prepared in accordance with established criteria. An unmodified opinion is expressed on the audited financial statements. The auditor’s report on the summary financial statements is dated later than the date of the auditor’s report on the financial statements from which summary financial statements are derived.
- Illustration 2: An auditor’s report on summary financial statements prepared in accordance with criteria developed by management and adequately disclosed in the summary financial statements. The auditor has determined that the applied criteria are acceptable in the circumstances. An unmodified opinion is expressed on the audited financial statements.
- Illustration 3: An auditor’s report on summary financial statements prepared in accordance with criteria developed by management and adequately disclosed in the summary financial statements. The auditor has determined that the applied criteria are acceptable in the circumstances. A qualified opinion is expressed on the audited financial statements.
- Illustration 4: An auditor’s report on summary financial statements prepared in accordance with criteria developed by management and adequately disclosed in the summary financial statements. The auditor has determined that the applied criteria are acceptable in the circumstances. An adverse opinion is expressed on the audited financial statements.
- Illustration 5: An auditor’s report on summary financial statements prepared in accordance with established criteria. An unmodified opinion is expressed on the audited financial statements. The auditor concludes that it is not possible to express an unmodified opinion on the summary financial statements.

Illustration 1:

Circumstances include the following:

- An unmodified opinion is expressed on the audited financial statements.
- Established criteria for the preparation of summary financial statements exist.
- The auditor's report on the summary financial statements is dated later than the date of the auditor's report on the financial statements from which the summary financial statements are derived.

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary balance sheet as at March 31, 20X1, the summary statement of profit & loss, and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated May 15, 20X1. Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements.

The summary financial statements do not contain all the disclosures required by the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") [applied in the preparation of the audited financial statements of ABC Company Ltd.]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company Ltd.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements in accordance with [Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") and accounting principles generally accepted in India].

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1 are a fair summary of those financial statements, in accordance with [Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") and accounting principles generally accepted in India].

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁰)
Membership Number

Place of Signature

Date

¹⁰ Partner or Proprietor, as the case may be.

Illustration 2:

Circumstances include the following:

- **An unmodified opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary balance sheet as at March 31, 20X1, the summary statement of profit & loss, and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated May 15, 20X1¹¹.

The summary financial statements do not contain all the disclosures required by the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") [applied in the preparation of the audited financial statements of ABC Company Ltd.]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company Ltd.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1 are a fair summary of those financial statements, on the basis described in Note X.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹²)
Membership Number

Place of Signature

Date

¹¹ When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements".

¹² Partner or Proprietor, as the case may be.

Illustration 3:

Circumstances include the following:

- **A qualified opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary balance sheet as at March 31, 20X1, the summary statement of profit & loss, and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1¹³. We expressed a qualified audit opinion on those financial statements in our report dated May 15, 20X1 (see below).

The summary financial statements do not contain all the disclosures required by the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") [applied in the preparation of the audited financial statements of ABC Company Ltd.]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company Ltd.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1 are a fair summary of those financial statements, on the basis described in Note X. However, the summary financial statements are misstated to the equivalent extent as the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1.

The misstatement of the audited financial statements is described in our qualified audit opinion in our report dated May 15, 20X1. Our qualified audit opinion is based on the fact that the company's inventories are carried in the balance sheet in those financial statements at Rs. XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standard (AS) 2, "Valuation of Inventories". The company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net income and shareholders' equity would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX, respectively. Our qualified audit opinion states that, except for the effects of the described matter, those financial statements give a true and fair view of the state

¹³ When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements".

I.600 Auditing Pronouncements

of affairs of ABC Company Ltd. as of March 31, 20X1, and (of) its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁴)
Membership Number

Place of Signature

Date

Illustration 4:

Circumstances include the following:

- **An adverse opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary balance sheet as at March 31, 20X1, the summary statement of profit & loss, and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1¹⁵.

The summary financial statements do not contain all the disclosures required by the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") [applied in the preparation of the audited financial statements of ABC Company Ltd.]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company Ltd.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

¹⁴ Partner or Proprietor, as the case may be.

¹⁵ When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements".

Denial of Opinion

In our report dated May 15, 20X1, we expressed an adverse audit opinion on the financial statements of ABC Company Ltd. for the year ended March 31, 20X1. The basis for our adverse audit opinion was [describe basis for adverse audit opinion]. Our adverse audit opinion stated that [describe adverse audit opinion].

Because of the significance of the matter discussed above, it is inappropriate to express an opinion on the summary financial statements of ABC Company Ltd. for the year ended March 31, 20X1.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁶)
Membership Number

Place of Signature

Date

Illustration 5:

Circumstances include the following:

- **An unmodified opinion is expressed on the audited financial statements.**
- **Established criteria for the preparation of summary financial statements exist.**
- **The auditor concludes that it is not possible to express an unmodified opinion on the summary financial statements.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary balance sheet as at March 31, 20X1, the summary statement of profit & loss, and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated May 15, 20X1¹⁷.

The summary financial statements do not contain all the disclosures required by the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") [applied in the preparation of the audited financial statements of ABC Company Ltd.]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company Ltd.

¹⁶ Partner or Proprietor, as the case may be.

¹⁷ When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements".

I.602 Auditing Pronouncements

Management's Responsibility for the Summary Audited Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements in accordance with [Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") and accounting principles generally accepted in India].

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

[Describe matter that caused the summary financial statements not to be a fair summary of the audited financial statements, in accordance with the applied criteria.]

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the summary financial statements referred to above are not a fair summary of the audited financial statements of ABC Company Ltd. for the year ended March 31, 20X1, in accordance with [Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act") and accounting principles generally accepted in India].

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁸)
Membership Number

Place of Signature

Date

¹⁸ Partner or Proprietor, as the case may be.

SRE 2400

Engagements to Review Historical Financial Statements

*(Effective for reviews of interim financial information for
periods beginning on or after April 1, 2016)*

Introduction

Scope of this SRE

1. This Standard on Review Engagements (SRE) deals with: (Ref: Para. A1)
 - (a) The practitioner's responsibilities when engaged to perform a review of historical financial statements, when the practitioner is not the auditor of the entity's financial statements; and
 - (b) The form and content of the practitioner's report on the financial statements.
2. This SRE does not address a review of an entity's financial statements or interim financial information performed by a practitioner who is the independent auditor of the entity's financial statements. (Ref: Para. A2)
3. This SRE is to be applied, adapted as necessary, to reviews of other historical financial information.

Relationship with SQC 1¹

4. Quality control systems, policies and procedures are the responsibility of the firm. SQC 1 applies to firms of professional accountants in respect of a firm's engagements to review financial statements.² The provisions of this SRE regarding quality control at the level of individual review engagements are premised on the basis that the firm is subject to SQC 1. (Ref: Para. A3-A4)

The Engagement to Review Historical Financial Statements

5. The review of historical financial statements is a limited assurance engagement, as described in the Framework for Assurance Engagements.³ (Ref: Para. A5-A6)
6. In a review of financial statements, the practitioner expresses a conclusion that is designed to enhance the degree of confidence of intended users regarding the preparation of an entity's financial statements in accordance with an applicable financial reporting framework. The practitioner's conclusion is based on the practitioner obtaining limited assurance. The practitioner's report includes a description of the nature of a review engagement as context for the readers of the report to be able to understand the conclusion.
7. The practitioner performs primarily inquiry and analytical procedures to obtain sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, expressed in accordance with the requirements of this SRE.
8. If the practitioner becomes aware of a matter that causes the practitioner to believe the financial statements may be materially misstated, the practitioner designs and performs additional procedures, as the

¹ Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

² SQC 1, paragraph 5.

³ Framework for Assurance Engagements, Paragraphs 6 and 10.

I.604 Auditing Pronouncements

practitioner considers necessary in the circumstances, to be able to conclude on the financial statements in accordance with this SRE.

Authority of this SRE

9. This SRE contains the objectives of the practitioner in following the SRE which provide the context in which the requirements of this SRE are set, and are intended to assist the practitioner in understanding what needs to be accomplished in a review engagement.

10. The SRE contains requirements, expressed using “shall,” that are designed to enable the practitioner to meet the stated objectives.

11. In addition, this SRE contains introductory material, definitions, and application and other explanatory material, that provide context relevant to a proper understanding of the SRE.

12. The application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. While such guidance does not itself impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in this SRE that assists in the application of the requirements.

Effective Date

13. This SRE is effective for reviews of financial statements for periods beginning on or after April 1, 2016.

Objectives

14. The practitioner’s objectives in a review of financial statements under this SRE are to:

(a) Obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to the practitioner’s attention that causes the practitioner to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) Report on the financial statements as a whole and communicate, as required by this SRE.

15. In all cases when limited assurance cannot be obtained and a qualified conclusion in the practitioner’s report is insufficient in the circumstances, this SRE requires that the practitioner either disclaim a conclusion in the report issued for the engagement or, where appropriate, withdraw from the engagement if withdrawal is possible under applicable law or regulation. (Ref. Para. A7-A9, A114-A115)

Definitions

16. The Glossary of Terms issued by the ICAI⁴ (“the Glossary”) includes the terms defined in this SRE as well as descriptions of other terms used in this SRE, to assist in consistent application and interpretation. For example, the terms “management” and “those charged with governance” used throughout this SRE are as defined in the Glossary. (Ref: Para. A10-A11)

17. For purposes of this SRE, the following terms have the meanings attributed below:

(a) Analytical procedures — Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

(b) Engagement risk — The risk that the practitioner expresses an inappropriate conclusion when the

⁴ The Glossary of Terms relating to Standards issued by the ICAI is contained in the Handbook of Auditing Pronouncements published by the ICAI.

financial statements are materially misstated.

- (c) General purpose financial statements — Financial statements prepared in accordance with a general purpose framework.
- (d) General purpose framework — A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.
- (e) Inquiry — Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.
- (f) Limited assurance — The level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion in accordance with this SRE. The combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the financial statements.⁵ (Ref: Para. A12)
- (g) Practitioner — A professional accountant in public practice. The term includes the engagement partner or other members of the engagement team, or, as applicable, the firm. Where this SRE expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “practitioner” is used.
- (h) Professional judgment — The application of relevant training, knowledge and experience, within the context provided by assurance, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the review engagement.
- (i) Relevant ethical requirements — Ethical requirements to which the engagement team is subject, which ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India (ICAI) together with other relevant pronouncements issued by the ICAI.
- (j) Special purpose financial statements — Financial statements prepared in accordance with a special purpose framework.
- (k) Special purpose framework — A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

Requirements

Conduct of a Review Engagement in Accordance with this SRE

18. The practitioner shall have an understanding of the entire text of this SRE, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A13)

Complying with Relevant Requirements

19. The practitioner shall comply with each requirement of this SRE, unless a requirement is not relevant to the review engagement. A requirement is relevant to the review engagement when the circumstances addressed by the requirement exist.

20. The practitioner shall not represent compliance with this SRE in the practitioner's report unless the practitioner has complied with all the requirements of this SRE relevant to the review engagement.

⁵ Attention is also drawn to paragraph 10 of the Framework for Assurance Engagements, issued by ICAI.

I.606 Auditing Pronouncements

Ethical Requirements

21. The practitioner shall comply with relevant ethical requirements, including those pertaining to independence. (Ref: Para. A14-A15)

Professional Skepticism and Professional Judgment

22. The practitioner shall plan and perform the engagement with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A16-A19)

23. The practitioner shall exercise professional judgment in conducting a review engagement. (Ref: Para. A20-A24)

Engagement Level Quality Control

24. The engagement partner shall possess competence in assurance skills and techniques, and competence in financial reporting, appropriate to the engagement circumstances. (Ref: Para. A25)

25. The engagement partner shall take responsibility for: (Ref: Para. A26-A29)

- (a) The overall quality of each review engagement to which that partner is assigned;
- (b) The direction, supervision, planning and performance of the review engagement in compliance with professional standards and applicable legal and regulatory requirements; (Ref: Para. A30)
- (c) The practitioner's report being appropriate in the circumstances; and
- (d) The engagement being performed in accordance with the firm's quality control policies, including the following:
 - (i) Being satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and engagements have been followed, and that conclusions reached are appropriate, including considering whether there is information that would lead the engagement partner to conclude that management lacks integrity; (Ref: Para. A31-A32)
 - (ii) Being satisfied that the engagement team collectively has the appropriate competence and capabilities, including assurance skills and techniques and expertise in financial reporting, to:
 - a. Perform the review engagement in accordance with professional standards and applicable legal and regulatory requirements; and
 - b. Enable a report that is appropriate in the circumstances to be issued; and
 - (iii) Taking responsibility for appropriate engagement documentation being maintained.

Relevant Considerations after Engagement Acceptance

26. If the engagement partner obtains information that would have caused the firm to decline the engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

Compliance with Relevant Ethical Requirements

27. Throughout the engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.

Monitoring

28. An effective system of quality control for a firm includes a monitoring process designed to provide the firm with reasonable assurance that the firm's policies and procedures relating to the system of quality control are relevant, adequate and operate effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the review engagement.

Acceptance and Continuance of Client Relationships and Review Engagements

Factors Affecting Acceptance and Continuance of Client Relationships and Review Engagements

29. Unless required by law or regulation, the practitioner shall not accept a review engagement if: (Ref: Para. A33-A34)

- (a) The practitioner is not satisfied:
 - (i) That there is a rational purpose for the engagement; or (Ref: Para. A35)
 - (ii) That a review engagement would be appropriate in the circumstances; (Ref: Para. A36)
- (b) The practitioner has reason to believe that relevant ethical requirements, including independence, will not be satisfied;
- (c) The practitioner's preliminary understanding of the engagement circumstances indicates that information needed to perform the review engagement is likely to be unavailable or unreliable; (Ref: Para. A37)
- (d) The practitioner has cause to doubt management's integrity such that it is likely to affect proper performance of the review; or (Ref: Para. A36)
- (e) Management or those charged with governance impose a limitation on the scope of the practitioner's work in the terms of a proposed review engagement such that the practitioner believes the limitation will result in the practitioner disclaiming a conclusion on the financial statements.

Preconditions for Accepting a Review Engagement

30. Prior to accepting a review engagement, the practitioner shall: (Ref: Para. A38)

- (a) Determine whether the financial reporting framework applied in the preparation of the financial statements is acceptable including, in the case of special purpose financial statements, obtaining an understanding of the purpose for which the financial statements are prepared and of the intended users; and (Ref: Para. A39-A45)
- (b) Obtain the agreement of management that it acknowledges and understands its responsibilities: (Ref: Para. A46-A49)
 - (i) For preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - (iii) To provide the practitioner with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
 - b. Additional information that the practitioner may request from management for the purpose of the review; and
 - c. Unrestricted access to persons within the entity from whom the practitioner determines it necessary to obtain evidence.

I.608 Auditing Pronouncements

31. If the practitioner is not satisfied as to any of the matters set out above as preconditions for accepting a review engagement, the practitioner shall discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the practitioner as to those matters, the practitioner shall not accept the proposed engagement unless required by law or regulation to do so. However, an engagement conducted under such circumstances does not comply with this SRE. Accordingly, the practitioner shall not include any reference within the practitioner's report to the review having been conducted in accordance with this SRE.

32. If it is discovered after the engagement has been accepted that the practitioner is not satisfied as to any of the above preconditions, the practitioner shall discuss the matter with management or those charged with governance, and shall determine:

- (a) Whether the matter can be resolved;
- (b) Whether it is appropriate to continue with the engagement; and
- (c) Whether and, if so, how to communicate the matter in the practitioner's report.

Additional Considerations When the Wording of the Practitioner's Report Is Prescribed by Law or Regulation

33. The practitioner's report issued for the review engagement shall refer to this SRE only if the report complies with the requirements of paragraph 86.

34. In some cases, when the review is performed pursuant to the specific law or regulation applicable to the entity, such law or regulation may prescribe the layout or wording of the practitioner's report in a form or in terms that are significantly different from the requirements of this SRE. In those circumstances, the practitioner shall evaluate whether users might misunderstand the assurance obtained from the review of the financial statements and, if so, whether additional explanation in the practitioner's report can mitigate possible misunderstanding. (Ref: Para. A50, A141)

35. If the practitioner concludes that additional explanation in the practitioner's report cannot mitigate possible misunderstanding, the practitioner shall not accept the review engagement unless required by law or regulation to do so. A review conducted in accordance with such law or regulation does not comply with this SRE. Accordingly, the practitioner shall not include any reference within the practitioner's report to the review having been conducted in accordance with this SRE. (Ref: Para. A50, A141)

Agreeing the Terms of Engagement

36. The practitioner shall agree the terms of the engagement with management or those charged with governance, as appropriate, prior to performing the engagement.

37. The agreed terms of engagement shall be recorded in an engagement letter or other suitable form of written agreement, and shall include: (Ref: Para. A51-A53, A55)

- (a) The intended use and distribution of the financial statements, and any restrictions on use or distribution where applicable;
- (b) Identification of the applicable financial reporting framework;
- (c) The objective and scope of the review engagement;
- (d) The responsibilities of the practitioner;
- (e) The responsibilities of management, including those in paragraph 30(b); (Ref: Para. A46-A49, A54)
- (f) A statement that the engagement is not an audit, and that the practitioner will not express an audit opinion on the financial statements; and
- (g) Reference to the expected form and content of the report to be issued by the practitioner, and a

statement that there may be circumstances in which the report may differ from its expected form and content.

Recurring Engagements

38. On recurring review engagements, the practitioner shall evaluate whether circumstances, including changes in the engagement acceptance considerations, require the terms of engagement to be revised and whether there is a need to remind management or those charged with governance, as appropriate, of the existing terms of engagement. (Ref: Para. A56)

Acceptance of a Change in the Terms of the Review Engagement

39. The practitioner shall not agree to a change in the terms of the engagement where there is no reasonable justification for doing so. (Ref: Para. A57-A59)

40. If, prior to completing the review engagement, the practitioner is requested to change the engagement to an engagement for which no assurance is obtained, the practitioner shall determine whether there is reasonable justification for doing so. (Ref: Para. A60-A61)

41. If the terms of engagement are changed during the course of the engagement, the practitioner and management or those charged with governance, as appropriate, shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

Communication with Management and Those Charged with Governance

42. The practitioner shall communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the review engagement, all matters concerning the review engagement that, in the practitioner's professional judgment, are of sufficient importance to merit the attention of management or those charged with governance, as appropriate. (Ref: Para. A62-A68)

Performing the Engagement

Materiality in a Review of Financial Statements

43. The practitioner shall determine materiality for the financial statements as a whole, and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures. (Ref: Para. A69-A72)

44. The practitioner shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the review that would have caused the practitioner to have determined a different amount initially. (Ref: Para. A73)

The Practitioner's Understanding

45. The practitioner shall obtain an understanding of the entity and its environment, and the applicable financial reporting framework, to identify areas in the financial statements where material misstatements are likely to arise and thereby provide a basis for designing procedures to address those areas. (Ref: Para. A74-A76)

46. The practitioner's understanding shall include the following: (Ref: Para. A77, A86, A88)

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework;
- (b) The nature of the entity, including:
 - (i) Its operations;
 - (ii) Its ownership and governance structure;
 - (iii) The types of investments that the entity is making and plans to make;

I.610 Auditing Pronouncements

- (iv) The way that the entity is structured and how it is financed; and
- (v) The entity's objectives and strategies;
- (c) The entity's accounting systems and accounting records; and
- (d) The entity's selection and application of accounting policies.

Designing and Performing Procedures

47. In obtaining sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, the practitioner shall design and perform inquiry and analytical procedures: (Ref: Para. A78-A82, A86, A88)

- (a) To address all material items in the financial statements, including disclosures; and
- (b) To focus on addressing areas in the financial statements where material misstatements are likely to arise.

48. The practitioner's inquiries of management and others within the entity, as appropriate, shall include the following: (Ref: Para. A83-A86)

- (a) How management makes the significant accounting estimates required under the applicable financial reporting framework;
- (b) The identification of related parties and related party transactions, including the purpose of those transactions;
- (c) Whether there are significant, unusual or complex transactions, events or matters that have affected or may affect the entity's financial statements, including:
 - (i) Significant changes in the entity's business activities or operations;
 - (ii) Significant changes to the terms of contracts that materially affect the entity's financial statements, including terms of finance and debt contracts or covenants;
 - (iii) Significant journal entries or other adjustments to the financial statements;
 - (iv) Significant transactions occurring or recognized near the end of the reporting period;
 - (v) The status of any uncorrected misstatements identified during previous engagements; and
 - (vi) Effects or possible implications for the entity of transactions or relationships with related parties;
- (d) The existence of any actual, suspected or alleged:
 - (i) Fraud or illegal acts affecting the entity; and
 - (ii) Non-compliance with provisions of laws and regulations that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations;
- (e) Whether management has identified and addressed events occurring between the date of the financial statements and the date of the practitioner's report that require adjustment of, or disclosure in, the financial statements;
- (f) The basis for management's assessment of the entity's ability to continue as a going concern; (Ref: Para. A87)
- (g) Whether there are events or conditions that appear to cast doubt on the entity's ability to continue as a going concern;
- (h) Material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements, including disclosures; and

- (i) Material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration.

49. In designing analytical procedures, the practitioner shall consider whether the data from the entity's accounting system and accounting records are adequate for the purpose of performing the analytical procedures. (Ref: Para. A88-A90)

Procedures to Address Specific Circumstances

Related Parties⁶

50. During the review, the practitioner shall remain alert for arrangements or information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the practitioner.

51. If the practitioner identifies significant transactions outside the entity's normal course of business in the course of performing the review, the practitioner shall inquire of management about:

- (a) The nature of those transactions;
- (b) Whether related parties could be involved; and
- (c) The business rationale (or lack thereof) of those transactions.

Fraud and non-compliance with laws or regulations

52. When there is an indication that fraud or non-compliance with laws or regulations, or suspected fraud or non-compliance with laws or regulations, has occurred in the entity, the practitioner shall:

- (a) Communicate that matter to the appropriate level of senior management or those charged with governance as appropriate;
- (b) Request management's assessment of the effect(s), if any, on the financial statements;
- (c) Consider the effect, if any, of management's assessment of the effects of fraud or non-compliance with laws or regulations communicated to the practitioner on the practitioner's conclusion on the financial statements and on the practitioner's report; and
- (d) Determine whether there is a responsibility to report the occurrence or suspicion of fraud or illegal acts to a party outside the entity. (Ref: Para. A91)

Going concern

53. A review of financial statements includes consideration of the entity's ability to continue as a going concern. In considering management's assessment of the entity's ability to continue as a going concern, the practitioner shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation where a longer period is specified.

54. If, during the performance of the review, the practitioner becomes aware of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern, the practitioner shall: (Ref: Para. A92)

- (a) Inquire of management about plans for future actions affecting the entity's ability to continue as a going concern and about the feasibility of those plans, and also whether management believes the outcome of those plans will improve the situation regarding the entity's ability to continue as a going concern;
- (b) Evaluate the results of those inquiries, to consider whether management's responses provide a sufficient basis to:

⁶ As defined in the "Glossary of Terms" contained in Volume I of the Handbook of Auditing Pronouncements.

I.612 Auditing Pronouncements

- (i) Continue to present the financial statements on the going concern basis if the applicable financial reporting framework includes the assumption of an entity's continuance as a going concern; or
 - (ii) Conclude whether the financial statements are materially misstated, or are otherwise misleading regarding the entity's ability to continue as a going concern; and
- (c) Consider management's responses in light of all relevant information of which the practitioner is aware as a result of the review.

Use of work performed by others

55. In performing the review, it may be necessary for the practitioner to use work performed by other practitioners, or the work of an individual or organization possessing expertise in a field other than accounting or assurance. If the practitioner uses work performed by another practitioner or an expert in the course of performing the review, the practitioner shall take appropriate steps to be satisfied that the work performed is adequate for the practitioner's purposes. (Ref: Para. A79)

Reconciling the Financial Statements to the Underlying Accounting Records

56. The practitioner shall obtain evidence that the financial statements agree with, or reconcile to, the entity's underlying accounting records. (Ref: Para. A93)

Additional Procedures When the Practitioner Becomes Aware that the Financial Statements May Be Materially Misstated

57. If the practitioner becomes aware of a matter(s) that causes the practitioner to believe the financial statements may be materially misstated, the practitioner shall design and perform additional procedures sufficient to enable the practitioner to: (Ref: Para. A94-A98)

- (a) Conclude that the matter(s) is not likely to cause the financial statements as a whole to be materially misstated; or
- (b) Determine that the matter(s) causes the financial statements as a whole to be materially misstated.

Subsequent Events

58. If the practitioner becomes aware of events occurring between the date of the financial statements and the date of the practitioner's report that require adjustment of, or disclosure in, the financial statements, the practitioner shall request management to correct those misstatements.

59. The practitioner has no obligation to perform any procedures regarding the financial statements after the date of the practitioner's report. However, if, after the date of the practitioner's report but before the date the financial statements are issued, a fact becomes known to the practitioner that, had it been known to the practitioner at the date of the practitioner's report, may have caused the practitioner to amend the report, the practitioner shall:

- (a) Discuss the matter with management or those charged with governance, as appropriate;
- (b) Determine whether the financial statements need amendment; and
- (c) If so, inquire how management intends to address the matter in the financial statements.

60. If management does not amend the financial statements in circumstances where the practitioner believes they need to be amended, and the practitioner's report has already been provided to the entity, the practitioner shall notify management and those charged with governance not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the practitioner shall take appropriate action to seek to prevent reliance on the practitioner's report.

Written Representations

61. The practitioner shall request management to provide a written representation that management has fulfilled its responsibilities described in the agreed terms of engagement. The written representation shall include that: (Ref: Para. A99-A101)

- (a) Management has fulfilled its responsibility for the preparation of financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and has provided the practitioner with all relevant information and access to information as agreed in the terms of the engagement; and
- (b) All transactions have been recorded and are reflected in the financial statements. If law or regulation requires management to make written public statements about its responsibilities, and the practitioner determines that such statements provide some or all of the representations required by subparagraphs (a)-(b), the relevant matters covered by such statements need not be included in the written representation.

62. The practitioner shall also request management's written representations that management has disclosed to the practitioner: (Ref: Para. A100)

- (a) The identity of the entity's related parties and all the related party relationships and transactions of which management is aware;
- (b) Significant facts relating to any frauds or suspected frauds known to management that may have affected the entity;
- (c) Known actual or possible non-compliance with laws and regulations for which the effects of non-compliance affect the entity's financial statements;
- (d) All information relevant to use of the going concern assumption in the financial statements;
- (e) That all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure, have been adjusted or disclosed;
- (f) Material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements, including disclosures; and
- (g) Material non-monetary transactions or transactions for no consideration undertaken by the entity in the financial reporting period under consideration.

63. If management does not provide one or more of the requested written representations, the practitioner shall: (Ref: Para. A99)

- (a) Discuss the matter with management and those charged with governance, as appropriate;
- (b) Re-evaluate the integrity of management, and evaluate the effect that this may have on the reliability of representations (oral or written) and evidence in general; and
- (c) Take appropriate actions, including determining the possible effect on the conclusion in the practitioner's report in accordance with this SRE.

64. The practitioner shall disclaim a conclusion on the financial statements, or withdraw from the engagement if withdrawal is possible under applicable law or regulation, as appropriate, if:

- (a) The practitioner concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable; or
- (b) Management does not provide the required representations required by paragraph 61.

I.614 Auditing Pronouncements

Date of and Period(s) Covered by Written Representations

65. The date of the written representations shall be as near as practicable to, but not after, the date of the practitioner's report. The written representations shall be for all financial statements and period(s) referred to in the practitioner's report.

Evaluating Evidence Obtained from the Procedures Performed

66. The practitioner shall evaluate whether sufficient appropriate evidence has been obtained from the procedures performed and, if not, the practitioner shall perform other procedures judged by the practitioner to be necessary in the circumstances to be able to form a conclusion on the financial statements. (Ref: Para. A102)

67. If the practitioner is not able to obtain sufficient appropriate evidence to form a conclusion, the practitioner shall discuss with management and those charged with governance, as appropriate, the effects such limitations have on the scope of the review. (Ref: Para. A103-A104)

Evaluating the Effect on the Practitioner's Report

68. The practitioner shall evaluate the evidence obtained from the procedures performed to determine the effect on the practitioner's report. (Ref: Para. A102)

Forming the Practitioner's Conclusion on the Financial Statements

Consideration of the Applicable Financial Reporting Framework in Relation to the Financial Statements

69. In forming the conclusion on the financial statements, the practitioner shall:

- (a) Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework; (Ref: Para. A105-A106)
- (b) Consider whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:
 - (i) The terminology used in the financial statements, including the title of each financial statement, is appropriate;
 - (ii) The financial statements adequately disclose the significant accounting policies selected and applied;
 - (iii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
 - (iv) Accounting estimates made by management appear reasonable;
 - (v) The information presented in the financial statements appears relevant, reliable, comparable, and understandable; and
 - (vi) The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements. (Ref: Para. A107-A109)

70. The practitioner shall consider the impact of:

- (a) Uncorrected misstatements identified during the review, and in the previous year's review of the entity's financial statements, on the financial statements as a whole; and
- (b) Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A110-A111)

71. If the financial statements are prepared using a fair presentation framework, the practitioner's

consideration shall also include: (Ref: Para. A108)

- (a) The overall presentation, structure and content of the financial statements in accordance with the applicable framework; and
- (b) Whether the financial statements, including the related notes, appear to represent the underlying transactions and events in a manner that achieves fair presentation or gives a true and fair view, as appropriate, in the context of the financial statements as a whole.

Form of the Conclusion

72. The practitioner's conclusion on the financial statements, whether unmodified or modified, shall be expressed in the appropriate form in the context of the financial reporting framework applied in the financial statements.

Unmodified Conclusion

73. The practitioner shall express an unmodified conclusion in the practitioner's report on the financial statements as a whole when the practitioner has obtained limited assurance to be able to conclude that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.

74. When the practitioner expresses an unmodified conclusion, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate: (Ref: Para. A112-A113)

- (a) "Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or
- (b) "Based on our review, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

Modified Conclusion

75. The practitioner shall express a modified conclusion in the practitioner's report on the financial statements as a whole when:

- (a) The practitioner determines, based on the procedures performed and the evidence obtained, that the financial statements are materially misstated; or
- (b) The practitioner is unable to obtain sufficient appropriate evidence in relation to one or more items in the financial statements that are material in relation to the financial statements as a whole.

76. When the practitioner modifies the conclusion expressed on the financial statements, the practitioner shall:

- (a) Use the heading "Qualified Conclusion," "Adverse Conclusion" or "Disclaimer of Conclusion," as appropriate, for the conclusion paragraph in the practitioner's report; and
- (b) Provide a description of the matter giving rise to the modification, under an appropriate heading (for example, "Basis for Qualified Conclusion," "Basis for Adverse Conclusion" or "Basis for Disclaimer of Conclusion," as appropriate), in a separate paragraph in the practitioner's report immediately before the conclusion paragraph (referred to as the basis for conclusion paragraph).

Financial statements are materially misstated

77. If the practitioner determines that the financial statements are materially misstated, the practitioner

I.616 Auditing Pronouncements

shall express:

- (a) A qualified conclusion, when the practitioner concludes that the effects of the matter(s) giving rise to the modification are material, but not pervasive to the financial statements; or
- (b) An adverse conclusion, when the effects of the matter(s) giving rise to the modification are both material and pervasive to the financial statements.

78. When the practitioner expresses a qualified conclusion on the financial statements because of a material misstatement, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

- (a) "Based on our review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or
- (b) "Based on our review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

79. When the practitioner expresses an adverse conclusion on the financial statements, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

- (a) "Based on our review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or
- (b) "Based on our review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

80. In the basis for conclusion paragraph, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the practitioner shall:

- (a) Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures), unless impracticable, in which case the practitioner shall so state;
- (b) Explain how disclosures are misstated if the material misstatement relates to narrative disclosures; or
- (c) Describe the nature of omitted information if the material misstatement relates to the non-disclosure of information required to be disclosed. Unless prohibited by law or regulation, the practitioner shall include the omitted disclosures where practicable to do so.

Inability to obtain sufficient appropriate evidence

81. If the practitioner is unable to form a conclusion on the financial statements due to inability to obtain sufficient appropriate evidence, the practitioner shall:

- (a) Express a qualified conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive; or
- (b) Disclaim a conclusion if the practitioner concludes that the possible effects on the financial statements

of undetected misstatements, if any, could be both material and pervasive.

82. The practitioner shall withdraw from the engagement if the following conditions are present: (Ref: Para. A114-A116)

- (a) Due to a limitation on the scope of the review imposed by management after the practitioner has accepted the engagement, the practitioner is unable to obtain sufficient appropriate evidence to form a conclusion on the financial statements;
- (b) The practitioner has determined that the possible effects on the financial statements of undetected misstatements are material and pervasive; and
- (c) Withdrawal is possible under applicable law or regulation.

83. When the practitioner expresses a qualified conclusion on the financial statements due to inability to obtain sufficient appropriate evidence, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

- (a) "Based on our review, except for the possible effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or
- (b) "Based on our review, except for the possible effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

84. When disclaiming a conclusion on the financial statements the practitioner shall state in the conclusion paragraph that:

- (a) Due to the significance of the matter(s) described in the Basis for Disclaimer of Conclusion paragraph, the practitioner is unable to obtain sufficient appropriate evidence to form a conclusion on the financial statements; and
- (b) Accordingly, the practitioner does not express a conclusion on the financial statements.

85. In the basis for conclusion paragraph, in relation to either the qualified conclusion due to inability to obtain sufficient appropriate evidence or when the practitioner disclaims a conclusion, the practitioner shall include the reason(s) for the inability to obtain sufficient appropriate evidence.

The Practitioner's Report

86. The practitioner's report for the review engagement shall be in writing, and shall contain the following elements: (Ref: Para. A117-A120, A141, A143)

- (a) A title, which shall clearly indicate that it is the report of an independent practitioner for a review engagement;
- (b) The addressee(s), as required by the circumstances of the engagement;
- (c) An introductory paragraph that:
 - (i) Identifies the financial statements reviewed, including identification of the title of each of the statements contained in the set of financial statements and the date and period covered by each financial statement;
 - (ii) Refers to the summary of significant accounting policies and other explanatory information; and

I.618 Auditing Pronouncements

- (iii) States that the financial statements have been reviewed;
- (d) A description of the responsibility of management for the preparation of the financial statements, including an explanation that management is responsible for: (Ref: Para. A121-A124)
 - (i) Their preparation in accordance with the applicable financial reporting framework including, where relevant, their fair presentation;
 - (ii) Such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;
- (e) If the financial statements are special purpose financial statements:
 - (i) A description of the purpose for which the financial statements are prepared and, if necessary, the intended users, or reference to a note in the special purpose financial statements that contains that information; and
 - (ii) If management has a choice of financial reporting frameworks in the preparation of such financial statements, a reference within the explanation of management's responsibility for the financial statements to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances;
- (f) A description of the practitioner's responsibility to express a conclusion on the financial statements including reference to this SRE and, where relevant, applicable law or regulation; (Ref: Para. A125-126, A142)
- (g) A description of a review of financial statements and its limitations, and the following statements: (Ref: Para. A127)
 - (i) A review engagement under this SRE is a limited assurance engagement;
 - (ii) The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained; and
 - (iii) The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing (SAs), and, accordingly, the practitioner does not express an audit opinion on the financial statements;
- (h) A paragraph under the heading "Conclusion" that contains:
 - (i) The practitioner's conclusion on the financial statements as a whole in accordance with paragraphs 72-85, as appropriate; and
 - (ii) A reference to the applicable financial reporting framework used to prepare the financial statements. (Ref: Para. A128-A129)
- (i) When the practitioner's conclusion on the financial statements is modified:
 - (i) A paragraph under the appropriate heading that contains the practitioner's modified conclusion in accordance with paragraphs 72 and 75-85, as appropriate; and
 - (ii) A paragraph, under an appropriate heading, that provides a description of the matter(s) giving rise to the modification; (Ref: Para. A130)
- (j) A reference to the practitioner's obligation under this SRE to comply with relevant ethical requirements;
- (k) The date of the practitioner's report; (Ref: Para. A137-A140)
- (l) The practitioner's signature; and (Ref: Para. A131)
- (m) The place of signature.

Emphasis of Matter and Other Matter Paragraphs in the Practitioner's Report

Emphasis of Matter Paragraphs

87. The practitioner may consider it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the practitioner's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. In such cases, the practitioner shall include an Emphasis of Matter paragraph in the practitioner's report, provided the practitioner has obtained sufficient appropriate evidence to conclude that the matter is not likely to be materially misstated as presented in the financial statements. Such paragraph shall refer only to information presented or disclosed in the financial statements.

88. The practitioner's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the practitioner's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. (Ref: Para. A132-A133)

89. The practitioner shall include an Emphasis of Matter paragraph immediately after the paragraph that contains the practitioner's conclusion on the financial statements under the heading "Emphasis of Matter," or other appropriate heading.

Other Matter Paragraphs

90. If the practitioner considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the practitioner's judgment, is relevant to users' understanding of the review, the practitioner's responsibilities or the practitioner's report and this is not prohibited by law or regulation, the practitioner shall do so in a paragraph in the practitioner's report with the heading "Other Matter" or other appropriate heading.

Other Reporting Responsibilities

91. A practitioner may be requested to address other reporting responsibilities in the practitioner's report on the financial statements that are in addition to the practitioner's responsibilities under this SRE to report on the financial statements. In such situations, those other reporting responsibilities shall be addressed by the practitioner in a separate section in the practitioner's report headed "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the content of the section, following the section of the report headed "Report on the Financial Statements." (Ref: Para. A134-A136)

Date of the Practitioner's Report

92. The practitioner shall date the report no earlier than the date on which the practitioner has obtained sufficient appropriate evidence as the basis for the practitioner's conclusion on the financial statements, including being satisfied that: (Ref: Para. A137-A140)

- (a) All the statements that comprise the financial statements under the applicable financial reporting framework, including the related notes where applicable, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Documentation

93. The preparation of documentation for the review provides evidence that the review was performed in accordance with this SRE, and legal and regulatory requirements where relevant, and a sufficient and appropriate record of the basis for the practitioner's report. The practitioner shall document the following aspects of the engagement in a timely manner, sufficient to enable an experienced practitioner, having no previous connection with the engagement, to understand: (Ref: Para. A144)

- (a) The nature, timing, and extent of the procedures performed to comply with this SRE and applicable

I.620 Auditing Pronouncements

legal and regulatory requirements;

- (b) Results obtained from the procedures, and the practitioner's conclusions formed on the basis of those results; and
- (c) Significant matters arising during the engagement, the practitioner's conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

94. In documenting the nature, timing and extent of procedures performed as required in this SRE, the practitioner shall record:

- (a) Who performed the work and the date such work was completed; and
- (b) Who reviewed the work performed for the purpose of quality control for the engagement, and the date and extent of the review.

95. The practitioner shall also document discussions with management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters.

96. If, in the course of the engagement, the practitioner identified information that is inconsistent with the practitioner's findings regarding significant matters affecting the financial statements, the practitioner shall document how the inconsistency was addressed.

Application and Other Explanatory Material

Scope of this SRE (Ref: Para. 1-2)

A1. In performing a review of financial statements, the practitioner may be required to comply with legal or regulatory requirements, which may differ from the requirements established in this SRE. While the practitioner may find aspects of this SRE helpful in these circumstances, it is the responsibility of the practitioner to ensure compliance with all relevant legal, regulatory and professional obligations.

Reviews of Financial Information of Components in the Context of an Audit of the Financial Statements of a Group of Entities

A2. Review engagements in accordance with this SRE may be requested for component entities by the auditor of the financial statements of a group of entities. Such a review engagement performed in accordance with this SRE may be accompanied by a request from the group auditor to undertake additional work or procedures as needed in the circumstances of the group audit engagement.

Relationship with SQC 1 (Ref: Para. 4)

A3. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for assurance engagements, including review engagements. Those responsibilities are directed at establishing the firm's:

- Quality control system; and
- Related policies designed to achieve the objective of the quality control system and the firm's procedures to implement and monitor compliance with those policies, including policies and procedures that address each of the following elements:
 - Leadership responsibilities for quality within the firm.
 - Relevant ethical requirements.
 - Acceptance and continuance of client relationships and specific engagements.
 - Human resources.

- Engagement performance.
- Monitoring.

A4. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- (b) Reports issued by the firm⁷ or engagement partners are appropriate in the circumstances.⁸

The Engagement to Review Historical Financial Statements (Ref: Para. 5-8, 14)

A5. Reviews of financial statements may be performed for a wide range of entities that vary by type or size, or by the level of complexity in their financial reporting. In some cases, the review of financial statements of an entity may also be subject to the applicable laws or regulations and related reporting requirements.

A6. Reviews may be performed in a variety of circumstances. For example, they may be required for entities that are exempt from requirements specified in law or regulation for mandatory audit. Reviews may also be requested on a voluntary basis, such as in connection with financial reporting undertaken for arrangements under the terms of a private contract, or to support funding arrangements.

Objectives (Ref: Para. 15)

A7. This SRE requires the practitioner to disclaim a conclusion on the financial statements if:

- (a) The practitioner issues a report, or is required to issue a report for the engagement; and
- (b) The practitioner is unable to form a conclusion on the financial statements due to inability to obtain sufficient appropriate evidence, and the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

A8. The situation of being unable to obtain sufficient appropriate evidence in a review engagement (referred to as a scope limitation) may arise from:

- (a) Circumstances beyond the control of the entity;
- (b) Circumstances relating to the nature or timing of the practitioner's work; or
- (c) Limitations imposed by management or those charged with governance of the entity.

A9. This SRE sets out requirements and guidance for the practitioner when the practitioner encounters a scope limitation, either prior to accepting a review engagement, or during the engagement.

Definitions (Ref: Para. 16)

Use of the Terms "Management" and "Those Charged with Governance"

A10. The respective responsibilities of management and those charged with governance will differ between entities of various types. These differences affect the way the practitioner applies the requirements of this SRE in relation to management or those charged with governance. Accordingly, the phrase "management and, where appropriate, those charged with governance" used in various places throughout this SRE is intended to alert the practitioner to the fact that different entity environments may have different management and governance structures and arrangements.

A11. Various responsibilities relating to preparation of financial information and external financial reporting

⁷ It is clarified that in India the reports are not issued/signed in the firm's name, rather they are issued/signed on behalf of the firm by the sole practitioner, proprietor or a partner of the firm, as the case may be, in his individual name.

⁸ SQC 1, paragraph 3.

I.622 Auditing Pronouncements

will fall to either management or those charged with governance according to factors such as:

- The resources and structure of the entity; and
- The respective roles of management and those charged with governance within the entity as set out in relevant law or regulation or, if the entity is not regulated, in any formal governance or accountability arrangements established for the entity (for example, as recorded in contracts, a constitution or other type of establishment documents of the entity).

For example, in small entities there is often no separation of the management and governance roles. In larger entities, management is often responsible for execution of the business or activities of the entity and reporting thereon, while those charged with governance oversee management. In some entities, the responsibility for preparation of financial statements for an entity is the legal responsibility of those charged with governance, and in some other entities it is a management responsibility.

Limited Assurance - Use of the Term Sufficient Appropriate Evidence (Ref: Para. 17(f))

A12. Sufficient appropriate evidence is required to obtain limited assurance to support the practitioner's conclusion. Evidence is cumulative in nature and is primarily obtained from the procedures performed during the course of the review.

Conduct of a Review Engagement in Accordance with this SRE (Ref: Para. 18)

A13. This SRE does not override laws and regulations that govern a review of financial statements. In the event that those laws and regulations differ from the requirements of this SRE, a review conducted only in accordance with laws and regulations will not automatically comply with this SRE.

Ethical Requirements (Ref: Para. 21)

A14. The Code of Ethics issued by the ICAI establishes the fundamental principles of professional ethics practitioners must comply with, and provides a conceptual framework for applying those principles. The fundamental principles are:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behaviour.

The Code of Ethics also illustrates how the conceptual framework is to be applied in specific situations. In complying with the Code, threats to the practitioner's compliance with relevant ethical requirements are required to be identified and appropriately addressed.

A15. In the case of an engagement to review financial statements, the Code of Ethics requires that the practitioner be independent of the entity whose financial statements are reviewed. The Code of Ethics describes independence as comprising both independence of mind and independence in appearance. The practitioner's independence safeguards the practitioner's ability to form a conclusion without being affected by influences that might otherwise compromise that conclusion. Independence enhances the practitioner's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

Professional Skepticism and Professional Judgment

Professional Skepticism (Ref: Para. 22)

A16. Professional skepticism is necessary for the critical assessment of evidence in a review. This includes questioning inconsistencies and investigating contradictory evidence, and questioning the reliability of

responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of evidence obtained in the light of the engagement circumstances.

A17. Professional skepticism includes being alert to, for example:

- Evidence that is inconsistent with other evidence obtained.
- Information that calls into question the reliability of documents and responses to inquiries to be used as evidence.
- Conditions that may indicate possible fraud.
- Any other circumstances that suggest the need for additional procedures.

A18. Maintaining professional skepticism throughout the review is necessary if the practitioner is to reduce the risks of:

- Overlooking unusual circumstances.
- Over-generalizing when drawing conclusions from evidence obtained.
- Using inappropriate assumptions in determining the nature, timing, and extent of the procedures performed in the review, and evaluating the results thereof.

A19. The practitioner cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the practitioner of the need to maintain professional skepticism or allow the practitioner to be satisfied with evidence that is inadequate for the purpose of the review.

Professional Judgment (Ref: Para. 23)

A20. Professional judgment is essential to the proper conduct of a review engagement. This is because interpretation of relevant ethical requirements and the requirements of this SRE, and the need for informed decisions throughout the performance of a review engagement, require the application of relevant knowledge and experience to the facts and circumstances of the engagement. Professional judgment is necessary, in particular:

- Regarding decisions about materiality, and the nature, timing, and extent of procedures used to meet the requirements of this SRE, and to gather evidence.
- When evaluating whether the evidence obtained from the procedures performed reduces the engagement risk to a level that is acceptable in the engagement circumstances.
- When considering management's judgments in applying the entity's applicable financial reporting framework.
- When forming the conclusion on the financial statements based on the evidence obtained, including considering the reasonableness of the estimates made by management in preparing the financial statements.

A21. The distinguishing feature of the professional judgment expected of the practitioner is that it is exercised by a practitioner whose training, knowledge and experience, including in the use of assurance skills and techniques, have assisted in developing the necessary competencies to achieve reasonable judgments. Consultation on difficult or contentious matters during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, assists the practitioner in making informed and reasonable judgments.

I.624 Auditing Pronouncements

A22. The exercise of professional judgment in individual engagements is based on the facts and circumstances that are known by the practitioner throughout the engagement, including:

- Knowledge acquired from engagements carried out with respect to the entity's financial statements in prior periods, where applicable.
- The practitioner's understanding of the entity and its environment, including its accounting system, and of the application of the applicable financial reporting framework in the entity's industry.
- The extent to which the preparation and presentation of the financial statements require the exercise of management judgment.

A23. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of assurance and accounting principles, and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the practitioner up to the date of the practitioner's report.

A24. Professional judgment needs to be exercised throughout the engagement. It also needs to be appropriately documented in accordance with the requirements of this SRE. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement, or the evidence obtained.

Engagement Level Quality Control (Ref: Para. 24-25)

A25. Assurance skills and techniques include:

- Applying professional skepticism and professional judgment to planning and performing an assurance engagement, including obtaining and evaluating evidence;
- Understanding information systems and the role and limitations of internal control;
- Linking the consideration of materiality and engagement risks to the nature, timing and extent of procedures for the review;
- Applying procedures as appropriate to the review engagement, which may include other types of procedures in addition to inquiry and analytical procedures (such as inspection, re-calculation, re-performance, observation and confirmation);
- Systematic documentation practices; and
- Application of skills and practices relevant for writing reports for assurance engagements.

A26. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures applicable to the engagement, and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

A27. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in the context of the engagement partner taking responsibility for the overall quality on each review engagement, emphasize the fact that quality is essential in performing a review engagement, and the importance to the quality of the review engagement of:

- (a) Performing work that complies with professional standards and regulatory and legal requirements.
- (b) Complying with the firm's quality control policies and procedures as applicable.
- (c) Issuing a report for the engagement that is appropriate in the circumstances.
- (d) The engagement team's ability to raise concerns without fear of reprisals.

A28. Unless information provided by the firm or other parties suggests otherwise, the engagement team is entitled to rely on the firm's system of quality control. For example, the engagement team may rely on the

firm's system of quality control in relation to:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

In considering deficiencies identified in the firm's system of quality control that may affect the review engagement, the engagement partner may consider measures taken by the firm to rectify those deficiencies.

A29. A deficiency in the firm's system of quality control does not necessarily indicate that a review engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements, or that the practitioner's report was not appropriate.

Assignment of Engagement Teams (Ref: Para. 25(b))

A30. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, review engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and applicable legal and regulatory requirements.
- Technical expertise, including expertise with relevant information technology and specialized areas of accounting or assurance.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

Acceptance and Continuance of Client Relationships and Review Engagements (Ref: Para. 25(d)(i))

A31. SQC 1 requires the firm to obtain information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Information that assists the engagement partner in determining whether acceptance and continuance of client relationships and review engagements are appropriate may include information concerning:

- The integrity of the principal owners, key management and those charged with governance; and
- Significant matters that have arisen during the current or a previous review engagement, and their implications for continuing the relationship.

A32. If the engagement partner has cause to doubt management's integrity to a degree that is likely to affect proper performance of the review, it is not appropriate under this SRE to accept the engagement, unless required by law or regulation, as doing so may lead to the practitioner being associated with the entity's financial statements in an inappropriate manner.

Acceptance and Continuance of Client Relationships and Review Engagements (Ref: Para. 29)

A33. The practitioner's consideration of engagement continuance, and relevant ethical requirements, including independence, occurs throughout the engagement, as conditions and changes in circumstances occur. Performing initial procedures on engagement continuance and evaluation of relevant ethical requirements (including independence) at the beginning of an engagement informs the practitioner's decisions and actions prior to the performance of other significant activities for the engagement.

Factors Affecting Acceptance and Continuance of Client Relationships and Review Engagements

(Ref: Para. 29)

A34. Assurance engagements may only be accepted when the engagement exhibits certain characteristics⁹ that are conducive to achieving the practitioner's objectives specified for the engagement.

Rational Purpose (Ref: Para. 29(a)(i))

A35. It may be unlikely that there is a rational purpose for the engagement if, for example:

- (a) There is a significant limitation on the scope of the practitioner's work;
- (b) The practitioner suspects the engaging party intends to associate the practitioner's name with the financial statements in an inappropriate manner; or
- (c) The engagement is intended to meet compliance requirements of relevant law or regulation and such law or regulation requires the financial statements to be audited.

Review Engagement is Appropriate (Ref: Para. 29(a)(ii) and 29(d))

A36. When the practitioner's preliminary understanding of the engagement circumstances indicates that accepting a review engagement would not be appropriate, the practitioner may consider recommending that another type of engagement be undertaken. Depending on the circumstances, the practitioner may, for example, believe that performance of an audit engagement would be more appropriate than a review. In other cases, if the engagement circumstances preclude performance of an assurance engagement, the practitioner may recommend a compilation engagement, or other accounting services engagement, as appropriate.

Information Needed to Perform the Review Engagement (Ref: Para. 29(c))

A37. An example of where the practitioner may have cause to doubt that the information needed to perform the review will be available or reliable is where the accounting records necessary for purposes of performing analytical procedures are suspected to be substantially inaccurate or incomplete. This consideration is not directed at the need that sometimes arises in the course of a review engagement to assist management by recommending adjusting entries required to finalize the financial statements prepared by management.

Preconditions for Accepting a Review Engagement (Ref: Para. 30)

A38. This SRE also requires the practitioner to ascertain certain matters, upon which it is necessary for the practitioner and the entity's management to agree, and which are within the control of the entity, prior to the practitioner accepting the engagement.

The Applicable Financial Reporting Framework (Ref: Para. 30(a))

A39. A condition for acceptance of an assurance engagement is that the criteria¹⁰ referred to in the definition of an assurance engagement are suitable and available to intended users.¹¹ For purposes of this SRE, the applicable financial reporting framework provides the criteria the practitioner uses to review the financial statements including, where relevant, the fair presentation of the financial statements. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, including what constitutes a complete set of financial statements.

Acceptability of the applicable financial reporting framework

A40. Without an acceptable financial reporting framework, management does not have an appropriate basis

⁹ Framework for Assurance Engagements, paragraph 16.

¹⁰ Framework for Assurance Engagements, paragraph 33.

¹¹ Framework for Assurance Engagements, paragraph 16(b)(ii).

for the preparation of the financial statements and the practitioner does not have suitable criteria for the review of the financial statements.

A41. The practitioner's determination of the acceptability of the financial reporting framework applied in the financial statements is made in the context of the practitioner's understanding of who the intended users of the financial statements are. The intended users are the person, persons or group of persons for whom the practitioner prepares the report. The practitioner may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it.

A42. In many cases, in the absence of any indications to the contrary, the practitioner may presume that the applicable financial reporting framework is acceptable (for example, a financial reporting framework that is prescribed by law or regulation governing the entity to be used in the preparation of general purpose financial statements for certain types of entities).

A43. Factors that are relevant to the practitioner's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not-for-profit organization).
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users).
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement).
- Whether the applicable financial reporting framework is prescribed in relevant law or regulation.

A44. If the financial reporting framework used to prepare the financial statements is not acceptable in view of the purpose of the financial statements and management will not agree to use of a financial reporting framework that is acceptable in the practitioner's view, the practitioner is required under this SRE to decline the engagement.

A45. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the review engagement has been accepted. When use of that financial reporting framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, the practitioner is required under this SRE to agree the new terms of the review engagement with management to reflect the change in the applicable financial reporting framework.

Responsibilities of Management and Those Charged with Governance (Ref: Para. 30(b), 37(e))

A46. The financial statements subject to review are those of the entity, prepared by management of the entity with oversight from those charged with governance. This SRE does not impose responsibilities on management and those charged with governance, nor does it override laws and regulations that govern their respective responsibilities. However, a review in accordance with this SRE is conducted on the premise that management, and those charged with governance as appropriate, have acknowledged certain responsibilities that are fundamental to the conduct of the review. The review of the financial statements does not relieve management and those charged with governance of their responsibilities.

A47. As part of its responsibility for the preparation of the financial statements, management is required to exercise judgment in making accounting estimates that are reasonable in the circumstances, and to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

I.628 Auditing Pronouncements

A48. Because of the significance of the preconditions for undertaking a review of financial statements, the practitioner is required under this SRE to obtain the agreement of management that it understands its responsibilities before accepting a review engagement. The practitioner may obtain management's agreement either orally or in writing. However, management's agreement is subsequently recorded within the written terms of the engagement.

A49. If management, and those charged with governance where appropriate, do not or will not acknowledge their responsibilities in relation to the financial statements, it is not appropriate to accept the engagement unless law or regulation requires the practitioner to do so. In circumstances where the practitioner is required to accept the review engagement, the practitioner may need to explain to management and those charged with governance, where different, the importance of these matters and the implications for the engagement.

Additional Considerations When the Wording of the Practitioner's Report is Prescribed by Law or Regulation (Ref: Para. 34-35)

A50. This SRE requires the practitioner to not represent compliance with this SRE unless the practitioner has complied with all the requirements of this SRE that are relevant to the review engagement. Law or regulation may prescribe matters in relation to an engagement that would ordinarily cause the practitioner to decline the engagement were it possible to do so, for example, if:

- The practitioner considers that the financial reporting framework prescribed by law or regulation is not acceptable; or
- The prescribed layout or wording of the practitioner's report is in a form or in terms that are significantly different from the layout or wording required by this SRE.

Under this SRE, a review conducted in these situations does not comply with this SRE and the practitioner cannot represent compliance with this SRE in the report issued for the engagement. Notwithstanding that the practitioner is not permitted to represent compliance with this SRE, the practitioner is, however, encouraged to apply this SRE, including the reporting requirements, to the extent practicable. When appropriate to avoid misunderstanding, the practitioner may consider including a statement in the report that the review is not conducted in accordance with this SRE.

Agreeing the Terms of Engagement

Engagement Letter or Other Form of Written Agreement (Ref: Para. 37)

A51. It is in the interests of both management and those charged with governance, and the practitioner, that the practitioner sends an engagement letter prior to performing the review engagement, to help avoid misunderstandings with respect to the engagement.

Form and content of the engagement letter

A52. The form and content of the engagement letter may vary for each engagement. In addition to including the matters required by this SRE, an engagement letter may make reference to, for example:

- Arrangements concerning the involvement of other practitioners and experts in the review engagement.
- Arrangements to be made with the predecessor practitioner, if any, in the case of an initial engagement.
- The fact that a review engagement will not satisfy any statutory or third party requirements for an audit.
- The expectation that management will provide written representations to the practitioner.
- The agreement of management to inform the practitioner of facts that may affect the financial statements of which management may become aware during the period from the date of the practitioner's report to the date the financial statements are issued.

- A request for management to acknowledge receipt of the engagement letter and to agree to the terms of the engagement outlined therein.

Review of components of groups of entities

A53. The auditor of the financial statements of a group of entities may request that a practitioner perform a review of the financial information of a component entity of the group. Depending on the instructions of the group auditor, a review of the financial information of a component may be performed in accordance with this SRE. The group auditor may also specify additional procedures to supplement the work done for the review performed under this SRE. Where the practitioner conducting the review is the auditor of the component entity's financial statements, the review is not performed in accordance with this SRE.

Responsibilities of Management prescribed by law or regulation (Ref: Para. 37(e))

A54. If, in the circumstances of the engagement, the practitioner concludes that it is not necessary to record certain terms of the engagement in an engagement letter, the practitioner is still required to seek the written agreement from management, and those charged with governance where appropriate, required under this SRE that they acknowledge and understand their responsibilities set out in this SRE. This written agreement may use the wording of the law or regulation if the law or regulation establishes responsibilities for management that are equivalent in effect to those described in this SRE.

Illustrative Engagement Letter (Ref: Para. 37)

A55. An illustrative engagement letter for a review engagement is set out in Appendix 1 to this SRE.

Recurring Engagements (Ref: Para. 38)

A56. The practitioner may decide not to send a new engagement letter or other written agreement each period. However, the following factors may indicate that it is appropriate to revise the terms of the review engagement or to remind management and those charged with governance, as appropriate, of the existing terms of the engagement:

- Any indication that management misunderstands the objective and scope of the review.
- Any revised or special terms of the engagement.
- A recent change of senior management of the entity.
- A significant change in ownership of the entity.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements affecting the entity.
- A change in the applicable financial reporting framework.

Acceptance of a Change in the Terms of the Review Engagement

Request to Change the Terms of the Review Engagement (Ref: Para. 39)

A57. A request from the entity for the practitioner to change the terms of the review engagement may result from factors including:

- A change in circumstances affecting the need for the service.
- Misunderstanding as to the nature of a review engagement as originally requested.
- A restriction on the scope of the review engagement, whether imposed by management or caused by other circumstances.

A58. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change to

I.630 Auditing Pronouncements

the terms of the review engagement.

A59. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the practitioner is unable to obtain sufficient appropriate evidence for a material item in the financial statements, and management asks for the engagement to be changed to a related services engagement to avoid the expression of a modified conclusion by the practitioner.

Request to Change the Nature of the Engagement (Ref: Para. 40)

A60. Before agreeing to change a review engagement to another type of engagement or related service, a practitioner who was engaged to perform a review in accordance with this SRE may need to assess, in addition to the matters referred to in this SRE, any legal or contractual implications of the change.

A61. If the practitioner concludes that there is reasonable justification to change the review engagement to another type of engagement or related service, the work performed in the review engagement to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the other engagement or related service would not include reference to:

- (a) The original review engagement; or
- (b) Any procedures that may have been performed in the original review engagement, except where the review engagement is changed to an engagement to perform agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

Communication with Management and Those Charged with Governance (Ref: Para. 42)

A62. In a review engagement, the practitioner's communications with management and those charged with governance take the form of:

- (a) Inquiries the practitioner makes in the course of performing the procedures for the review; and
- (b) Other communications, in the context of having effective two-way communication to understand matters arising and to develop a constructive working relationship for the engagement.

A63. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant factors include the significance and nature of the matter, and any action expected to be taken by management or those charged with governance. For example, it may be appropriate to communicate a significant difficulty encountered during the review as soon as practicable if management or those charged with governance are able to assist the practitioner to overcome the difficulty.

A64. Law or regulation may restrict the practitioner's communication of certain matters with those charged with governance. For example, law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the practitioner's obligations of confidentiality and obligations to communicate may be complex. In such cases, the practitioner may consider obtaining legal advice.

Communicating Matters Concerning the Review

A65. Matters to be communicated to management or those charged with governance, as appropriate, under this SRE may include:

- The practitioner's responsibilities in the review engagement, as included in the engagement letter or other suitable form of written agreement.
- Significant findings from the review, for example:

- The practitioner's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
- Significant findings from the performance of procedures, including situations where the practitioner considered performance of additional procedures necessary under this SRE. The practitioner may need to confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.
- Matters arising that may lead to modification of the practitioner's conclusion.
- Significant difficulties, if any, encountered during the review; for example, unavailability of expected information; unexpected inability to obtain evidence that the practitioner considers necessary for the review; or restrictions imposed on the practitioner by management. In some circumstances, such difficulties may constitute a scope limitation that, if not addressed by management or those charged with governance, may lead to modification of the practitioner's conclusion or to the practitioner's withdrawal from the engagement in certain circumstances.

A66. In some entities, different persons are responsible for the management and the governance of an entity. In these circumstances, management may have the responsibility to communicate matters of governance interest to those charged with governance. Communication by management with those charged with governance of matters that the practitioner is required to communicate does not relieve the practitioner of the responsibility to also communicate them to those charged with governance. However, communication of these matters by management may affect the form or timing of the practitioner's communication with those charged with governance.

Communication with Third Parties

A67. In some entities, the practitioner may be required by law or regulation to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some cases the practitioner has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action.
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies or, in some cases, make such reports publicly available.

A68. Unless required by law or regulation to provide a third party with a copy of the practitioner's written communications with those charged with governance, the practitioner may need the prior consent of management or those charged with governance before doing so.

Performing the Engagement

Materiality in a Review of Financial Statements (Ref: Para. 43)

A69. The practitioner's consideration of materiality is made in the context of the applicable financial reporting framework. Some financial reporting frameworks discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a

I.632 Auditing Pronouncements

consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

A70. If present in the applicable financial reporting framework, a discussion of the concept of materiality provides a frame of reference for the practitioner in determining materiality for the review. If not present, the above considerations provide the practitioner with a frame of reference.

A71. The practitioner's determination of materiality is a matter of professional judgment, and is affected by the practitioner's perception of the needs of the intended users of the financial statements. In this context, it is reasonable for the practitioner to assume that users:

- Have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared, presented and reviewed to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.

Further, unless the review engagement is undertaken for financial statements that are intended to meet the particular needs of specific users, the possible effect of misstatements on specific users, whose information needs may vary widely, is not ordinarily considered.

A72. The practitioner's judgment about what is material in relation to the financial statements as a whole is the same regardless of the level of assurance obtained by a practitioner as the basis for expressing the conclusion on the financial statements.

Revising Materiality (Ref: Para. 44)

A73. The practitioner's determination of materiality for the financial statements as a whole may need to be revised during the engagement as a result of:

- A change in the circumstances that occurred during the review (for example, a decision to dispose of a major part of the entity's business).
- New information, or a change in the practitioner's understanding of the entity and its environment as a result of performing procedures for the review in accordance with this SRE (for example, if during the review it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole).

The Practitioner's Understanding (Ref: Para. 45-46)

A74. The practitioner uses professional judgment to determine the extent of the understanding of the entity and its environment required to perform the review of the entity's financial statements in accordance with this SRE. The practitioner's primary consideration is whether the understanding obtained is sufficient to meet the practitioner's objectives for the engagement. The breadth and depth of the overall understanding that the practitioner obtains is less than that possessed by management.

A75. Obtaining an understanding of the entity and its environment is a continual dynamic process of gathering, updating and analyzing information throughout the review engagement. The practitioner's understanding is obtained and applied on an iterative basis throughout performance of the engagement, and is updated as changes in conditions and circumstances occur. Initial procedures for engagement acceptance and continuance at the time of commencement of a review engagement are based on the practitioner's preliminary understanding of the entity and of the engagement circumstances. In a continuing client

relationship, the practitioner's understanding includes knowledge obtained from prior engagements performed by the practitioner in relation to the entity's financial statements and other financial information.

A76. The understanding establishes a frame of reference within which the practitioner plans and performs the review engagement, and exercises professional judgment throughout the engagement. Specifically, the understanding needs to be sufficient for the practitioner to be able to identify areas in the financial statements where material misstatements are likely to arise, to inform the practitioner's approach to designing and performing procedures to address those areas.

A77. In obtaining an understanding of the entity and its environment, and of the applicable financial reporting framework, the practitioner may also consider:

- Whether the entity is a component of a group of entities, or an associated entity of another entity.
- The complexity of the financial reporting framework.
- The entity's financial reporting obligations or requirements, and whether those obligations or requirements exist under applicable law or regulation or in the context of voluntary financial reporting arrangements established under formalized governance or accountability arrangements, for example, under contractual arrangements with third parties.
- Relevant provisions of laws and regulations that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations.
- The level of development of the entity's management and governance structure regarding management and oversight of the entity's accounting records and financial reporting systems that underpin preparation of the financial statements. Smaller entities often have fewer employees, which may influence how management exercises oversight. For example, segregation of duties may not be practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.
- The "tone at the top" and the entity's control environment through which the entity addresses risks relating to financial reporting and compliance with the entity's financial reporting obligations.
- The level of development and complexity of the entity's financial accounting and reporting systems and related controls through which the entity's accounting records and related information are maintained.
- The entity's procedures for recording, classifying and summarizing transactions, accumulating information for inclusion in the financial statements and related disclosures.
- The types of matters that required accounting adjustments in the entity's financial statements in prior periods.

Designing and Performing Procedures (Ref: Para. 47, 55)

A78. The planned nature, timing and extent of the procedures the practitioner considers are needed to obtain sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole are influenced by:

- (a) The requirements of this SRE; and
- (b) Requirements established under applicable law or regulation, including additional reporting requirements contained in applicable laws or regulations.

A79. When the practitioner is engaged to review the financial statements of a group of entities, the planned nature, timing and extent of the procedures for the review are directed at achieving the practitioner's

I.634 Auditing Pronouncements

objectives for the review engagement stated in this SRE, but in the context of the group financial statements.

A80. The requirements of this SRE relating to designing and performing inquiry and analytical procedures, and procedures addressing specific circumstances, are designed to enable the practitioner to achieve the objectives specified in this SRE. The circumstances of review engagements vary widely and, accordingly, there may be circumstances where the practitioner may consider it effective or efficient to design and perform other procedures. For example, if in the course of obtaining an understanding of the entity, the practitioner becomes aware of a significant contract the practitioner may choose to read the contract.

A81. The fact that the practitioner may deem it necessary to perform other procedures does not alter the practitioner's objective of obtaining limited assurance in relation to the financial statements as a whole.

Significant or Unusual Transactions

A82. The practitioner may consider, reviewing the accounting records with a view to identifying significant or unusual transactions that may require specific attention in the review.

Inquiry (Ref: Para. 46-48)

A83. In a review, inquiry includes seeking information of management and other persons within the entity, as the practitioner considers appropriate in the engagement circumstances. The practitioner may also extend inquiries to obtain non-financial data if appropriate. Evaluating the responses provided by management is integral to the inquiry process.

A84. Depending on the engagement circumstances, inquiries may also include inquiries about:

- Actions taken at meetings of owners, those charged with governance and committees thereof, and proceedings at other meetings, if any, that affect the information and disclosures contained in the financial statements.
- Communications the entity has received, or expects to receive or obtain, from regulatory agencies.
- Matters arising in the course of applying other procedures. When performing further inquiries in relation to identified inconsistencies, the practitioner considers the reasonableness and consistency of management's responses in light of the results obtained from other procedures, and the practitioner's knowledge and understanding of the entity and the industry in which it operates.

A85. Evidence obtained through inquiry is often the principal source of evidence about management intent. However, information available to support management's intent may be limited. In that case, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. Application of professional skepticism in evaluating responses provided by management is important to enable the practitioner to evaluate whether there are any matter(s) that would cause the practitioner to believe the financial statements may be materially misstated.

A86. Performing inquiry procedures assists the practitioner also in obtaining or updating the practitioner's understanding of the entity and its environment, to be able to identify areas where material misstatements are likely to arise in the financial statements.

Inquiry about the entity's ability to continue as a going concern (Ref: Para. 48(f))

A87. Often in smaller entities, management may not have prepared an assessment of the entity's ability to continue as a going concern, but instead may rely on knowledge of the business and anticipated future prospects. In these circumstances, it may be appropriate to discuss the medium and long-term prospects and financing of the entity with management, including consideration of whether management's contentions are not inconsistent with the practitioner's understanding of the entity.

Analytical Procedures (Ref: Para. 46-47, 49)

A88. In a review of financial statements, performing analytical procedures assists the practitioner in:

- Obtaining or updating the practitioner's understanding of the entity and its environment, including to be able to identify areas where material misstatements are likely to arise in the financial statements.
- Identifying inconsistencies or variances from expected trends, values or norms in the financial statements such as the level of congruence of the financial statements with key data, including key performance indicators.
- Providing corroborative evidence in relation to other inquiry or analytical procedures already performed.
- Serving as additional procedures when the practitioner becomes aware of matter(s) that cause the practitioner to believe that the financial statements may be materially misstated. An example of such an additional procedure is a comparative analysis of monthly revenue and cost figures across profit centers, branches or other components of the entity, to provide evidence about financial information contained in line items or disclosures contained in the financial statements.

A89. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analysis using statistical techniques. The practitioner may, for example, apply analytical procedures to evaluate the financial information underlying the financial statements through analysis of plausible relationships among both financial and non-financial data, and assessment of results for consistency with expected values with a view to identifying relationships and individual items that appear unusual, or that vary from expected trends or values. The practitioner would compare recorded amounts, or ratios developed from recorded amounts, to expectations developed by the practitioner from information obtained from relevant sources. Examples of sources of information the practitioner often uses to develop expectations, depending on the engagement circumstances, include:

- Financial information for comparable prior period(s), taking known changes into account.
- Information about expected operating and financial results, such as budgets or forecasts including extrapolations from interim or annual data.
- Relationships among elements of financial information within the period.
- Information regarding the industry in which the entity operates, such as gross margin information, or comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
- Relationships of financial information with relevant non-financial information, such as payroll costs to number of employees.

A90. The practitioner's consideration of whether data to be used for analytical procedures are satisfactory for the intended purpose(s) of those procedures is based on the practitioner's understanding of the entity and its environment, and is influenced by the nature and source of the data, and by the circumstances in which the data are obtained. The following considerations may be relevant:

- Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- Comparability of the information available. For example, broad industry data may need to be supplemented or be adjusted to be comparable to data of an entity that produces and sells specialized products;
- Nature and relevance of the information available; for example, whether the entity's budgets are established as results to be expected rather than as goals to be achieved; and

I.636 Auditing Pronouncements

- The knowledge and expertise involved in the preparation of the information, and related controls that are designed to ensure its completeness, accuracy and validity.
- Such controls may include, for example, controls over the preparation, review and maintenance of budgetary information.

Procedures to Address Specific Circumstances

Fraud and non-compliance with laws or regulations (Ref: Para. 52(d))

A91. Under this SRE, if the practitioner has identified or suspects fraud or illegal acts, the practitioner is required to determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the practitioner's professional duty to maintain the confidentiality of client information may preclude such reporting, the practitioner's legal responsibilities may override the duty of confidentiality in some circumstances.

Events or conditions that may cast doubt regarding use of the going concern assumption in the financial statements (Ref: Para. 54)

A92. The list of factors below gives examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. The list is not all inclusive, and the existence of one or more of the items does not always signify that uncertainty exists about whether the entity can continue as a going concern.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Reconciling the Financial Statements to the Underlying Accounting Records (Ref: Para. 56)

A93. The practitioner ordinarily obtains evidence that the financial statements agree with, or reconcile to, the underlying accounting records by tracing the financial statement amounts and balances to the relevant accounting records such as the general ledger, or to a summary record or schedule that reflects the agreement or reconciliation of the financial statement amounts with the underlying accounting records (such as a trial balance).

Performing Additional Procedures (Ref: Para. 57)

A94. Additional procedures are required under this SRE if the practitioner becomes aware of a matter that causes the practitioner to believe the financial statements may be materially misstated.

A95. The practitioner's response in undertaking additional procedures with respect to an item the practitioner has cause to believe may be materially misstated in the financial statements will vary, depending on the circumstances, and is a matter for the practitioner's professional judgment.

A96. The practitioner's judgment about the nature, timing and extent of additional procedures that are needed to obtain evidence to either conclude that a material misstatement is not likely, or determine that a material misstatement exists, is guided by:

- Information obtained from the practitioner's evaluation of the results of the procedures already performed;
- The practitioner's updated understanding of the entity and its environment obtained throughout the course of the engagement; and
- The practitioner's view on the persuasiveness of evidence needed to address the matter that causes the practitioner to believe that the financial statements may be materially misstated.

A97. Additional procedures focus on obtaining sufficient appropriate evidence to enable the practitioner to form a conclusion on matters that the practitioner believes may cause the financial statements to be materially misstated. The procedures may be:

- Additional inquiry or analytical procedures, for example, being performed in greater detail or being focused on the affected items (i.e. amounts or disclosures concerning the affected accounts or transactions as reflected in the financial statements); or
- Other types of procedures, for example, substantive test of details or external confirmations.

A98. The following example illustrates the practitioner's evaluation of the need to perform additional procedures, and the practitioner's response when the practitioner believes additional procedures are

necessary.

- In the course of performing the inquiry and analytical procedures for the review, the practitioner's analysis of accounts receivable shows a material amount of past due accounts receivable, for which there is no allowance for bad or doubtful debts.
- This causes the practitioner to believe that the accounts receivable balance in the financial statements may be materially misstated. The practitioner then inquires of management whether there are uncollectible accounts receivable that would need to be shown as being impaired.
- Depending on management's response, the practitioner's evaluation of the response may:
 - (a) Enable the practitioner to conclude that the accounts receivable balance is not likely to be materially misstated. In that case, no further procedures are required.
 - (b) Enable the practitioner to determine that the matter causes the financial statements to be materially misstated. No further procedures are required, and the practitioner would form the conclusion that the financial statements as a whole are materially misstated.
 - (c) Lead the practitioner to continue to believe that the accounts receivable balance is likely to be materially misstated, while not providing sufficient appropriate evidence for the practitioner to determine that they are in fact misstated. In that case, the practitioner is required to perform additional procedures, for example, requesting from management an analysis of amounts received for those accounts after the balance sheet date to identify uncollectible accounts receivable. The evaluation of the results of the additional procedures may enable the practitioner to get to (a) or (b) above. If not, the practitioner is required to:
 - (i) Continue performing additional procedures until the practitioner reaches either (a) or (b) above; or
 - (ii) If the practitioner is not able to either conclude that the matter is not likely to cause the financial statements as a whole to be materially misstated, or to determine that the matter does cause the financial statements as a whole to be materially misstated, then a scope limitation exists and the practitioner is not able to form an unmodified conclusion on the financial statements.

Written Representations (Ref: Para. 61-63)

A99. Written representations are an important source of evidence in a review engagement. If management modifies or does not provide the requested written representations, it may alert the practitioner to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

A100. In addition to the written representations required under this SRE, the practitioner may consider it necessary to request other written representations about the financial statements. These may be needed, for example, to complete the practitioner's evidence with respect to certain items or disclosures reflected in the financial statements where the practitioner considers such representations to be important in forming a conclusion on the financial statements on either a modified or unmodified basis.

A101. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of management's knowledge and belief. It is reasonable for the practitioner to accept such wording if the practitioner is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

Evaluating Evidence Obtained from the Procedures Performed (Ref: Para. 66-68)

A102. In some circumstances, the practitioner may not have obtained the evidence that the practitioner had expected to obtain through the design of primarily inquiry and analytical procedures and procedures addressing specific circumstances. In these circumstances, the practitioner considers that the evidence obtained from the procedures performed is not sufficient and appropriate to be able to form a conclusion on the financial statements. The practitioner may:

- Extend the work performed; or
- Perform other procedures judged by the practitioner to be necessary in the circumstances.

Where neither of these is practicable in the circumstances, the practitioner will not be able to obtain sufficient appropriate evidence to be able to form a conclusion and is required by this SRE to determine the effect on the practitioner's report, or on the practitioner's ability to complete the engagement, for example, if a member of management is unavailable at the time of the review to respond to the practitioner's inquiries on significant matters. This situation may arise even though the practitioner has not become aware of a matter(s) that causes the practitioner to believe the financial statements may be materially misstated, as addressed in paragraph 57.

Scope Limitations

A103. Inability to perform a specific procedure does not constitute a limitation on the scope of the review if the practitioner is able to obtain sufficient appropriate evidence by performing other procedures.

A104. Limitations on the scope of the review imposed by management may have other implications for the review, such as for the practitioner's consideration of areas where the financial statements are likely to be materially misstated, and engagement continuance.

Forming the Practitioner's Conclusion on the Financial Statements

Description of the Applicable Financial Reporting Framework (Ref: Para. 69(a))

A105. The description of the applicable financial reporting framework in the financial statements is important because it advises users of the financial statements of the framework on which the financial statements are based. If the financial statements are special purpose financial statements, they may be prepared under a special purpose financial reporting framework that is available only to the engaging party and the practitioner. Description of the special purpose financial reporting framework used is important as the special purpose financial statements may not be appropriate for any use other than the intended use identified for the special purpose financial statements.

A106. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (for example, "the financial statements are in substantial compliance with Accounting Standards issued by the ICAI or Accounting Standards notified by the Central Government under the Companies Act, 2013¹², or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable") is not an adequate description of that framework as it may mislead users of the financial statements.

Disclosure of Effects of Material Transactions and Events on Information Conveyed in the Financial Statements (Ref: Para. 69(b)(vi), 71)

A107. The practitioner is required under this SRE to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows.

¹² Read with the General Circular No. 15/2013 dated 13th September 2013 issued by the Ministry of Corporate Affairs.

I.640 Auditing Pronouncements

A108. In the case of financial statements prepared in accordance with the requirements of a fair presentation framework, management may need to include additional disclosures in the financial statements beyond those specifically required by the applicable financial reporting framework or, in extremely rare circumstances, to depart from a requirement in the framework, in order to achieve the fair presentation of the financial statements.

Considerations When a Compliance Framework is Used

A109. It will be extremely rare for the practitioner to consider financial statements prepared in accordance with a compliance framework to be misleading if, in accordance with this SRE, the practitioner has determined at the time of engagement acceptance that the framework is acceptable.

Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 70(b))

A110. In considering the qualitative aspects of the entity's accounting practices, the practitioner may become aware of possible bias in management's judgments. The practitioner may conclude that the cumulative effect of a lack of neutrality, together with the effect of apparent uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the practitioner's evaluation of whether the financial statements as a whole may be materially misstated include the following:

- The selective correction of apparent misstatements brought to management's attention during the review (for example, correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
- Possible management bias in the making of accounting estimates.

A111. Indicators of possible management bias do not necessarily mean there are misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the practitioner's consideration of whether the financial statements as a whole may be materially misstated.

Form of the Conclusion (Ref: Para. 74)

Description of the Information the Financial Statements Present

A112. In the case of financial statements prepared in accordance with a fair presentation framework, the practitioner's conclusion states that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements do not give a true and fair view of ... (or do not present fairly, in all material respects, ...) in accordance with [the applicable fair presentation framework]. In the case of many general purpose frameworks, for example, the financial statements are required to give a true and fair view of (or fairly present) the financial position of the entity as at the end of a period, and the entity's financial performance and cash flows for that period.

"Gives a true and fair view" or "present fairly, in all material respects"

A113. Whether the phrase "gives a true and fair view" or the phrase "present fairly, in all material respects," is used in any particular entity is determined by the law or regulation governing the review of financial statements of that entity, or by generally accepted practice in that regard. Where the relevant law or regulation requires the use of different wording, this does not affect the requirement in this SREs for the practitioner to evaluate the fair presentation of financial statements prepared in accordance with a fair presentation framework.

Inability to Form a Conclusion Due to a Management-Imposed Limitation on the Scope of the Review after Engagement Acceptance (Ref: Para. 15, 82)

A114. The practicality of withdrawing from the engagement may depend on the stage of completion of the

engagement at the time that management imposes the scope limitation. If the practitioner has substantially completed the review, the practitioner may decide to complete the review to the extent possible, disclaim a conclusion and explain the scope limitation in the paragraph in the report that describes the basis for disclaiming a conclusion.

A115. In certain circumstances, withdrawal from the engagement may not be possible if the practitioner is required by law or regulation to continue the engagement. For example, this may be the case for a practitioner appointed to review the financial statements of a public sector entity. It may also be the case in entities where the practitioner is appointed to review the financial statements covering a specific period, or appointed for a specific period, and is prohibited from withdrawing before the completion of the review of those financial statements or before the end of that period, respectively. The practitioner may also consider it necessary to include an Other Matter paragraph in the practitioner's report to explain why it is not possible for the practitioner to withdraw from the engagement.

Communication with Regulators or the Entity's Owners

A116. When the practitioner concludes that withdrawal from the engagement is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the practitioner to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

The Practitioner's Report (Ref: Para. 86-92)

A117. The written report encompasses reports issued in hard copy format and those using an electronic medium.

Elements of the Practitioner's Report (Ref: Para. 86)

A118. A title indicating the report is the report of an independent practitioner, for example, "Independent Practitioner's Review Report," affirms that the practitioner has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent practitioner's report from reports issued by others.

A119. Law or regulation applicable to the entity may specify to whom the practitioner's report is to be addressed. The practitioner's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being reviewed.

A120. When the practitioner is aware that the financial statements that have been reviewed will be included in a document that contains other information, such as a financial report, the practitioner may consider, if the form of presentation allows, identifying the page numbers on which the financial statements that have been reviewed are presented. This helps users to identify the financial statements to which the practitioner's report relates.

Management's Responsibility for the Financial Statements (Ref: Para. 86(d))

A121. The requirement of this SRE that the practitioner must obtain management's agreement that it acknowledges and understands its responsibilities, both in relation to the preparation of the financial statements and in relation to the review engagement, is fundamental to performing the review and reporting on the engagement. The description of management's responsibilities in the practitioner's report provides context for readers of the practitioner's report about management's responsibilities, as they relate to the review engagement performed.

A122. The practitioner's report need not refer specifically to "management" but instead may use the term that is appropriate in the context of the legal framework applicable to the entity. In some entities, the appropriate reference is to those charged with governance of the entity.

I.642 Auditing Pronouncements

A123. There may be circumstances when it is appropriate for the practitioner to add to the description of management's responsibilities as described in this SRE to reflect additional responsibilities that are relevant to the preparation of the financial statements in the context of law or regulation applicable to the entity, or due to the type of entity.

A124. In some entities, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of the accounting books and records, or accounting system. As books, records and systems are an integral part of internal control, this SRE does not use these descriptions or make any specific reference to them.

The Practitioner's Responsibility (Ref: Para. 86(f))

A125. The practitioner's report states that the practitioner's responsibility is to express a conclusion on the financial statements based on the review performed, in order to contrast the practitioner's responsibility with management's responsibility for preparation of the financial statements.

Reference to standards (Ref: Para. 86(f))

A126. The reference to the standards used by the practitioner for the review conveys to the users of the practitioner's report that the review has been conducted in accordance with established standards.

Communication of the Nature of a Review of Financial Statements (Ref: Para. 86(g))

A127. The description of the nature of a review engagement in the practitioner's report explains the scope and limitations of the engagement undertaken for the benefit of the readers of the report. This explanation clarifies, for avoidance of doubt, that the review is not an audit and that accordingly, the practitioner does not express an audit opinion on the financial statements.

Description of the Applicable Financial Reporting Framework and How it May Affect the Practitioner's Conclusion (Ref: Para. 86(h)(ii))

A128. The identification of the applicable financial reporting framework in the practitioner's conclusion is intended to advise users of the practitioner's report of the context in which that conclusion is expressed. It is not intended to limit the evaluation required in paragraph 30(a). The applicable financial reporting framework is identified in such terms as:

"... in accordance with the Financial Reporting Standards¹³ or

"... in accordance with accounting principles generally accepted in India ..."

A129. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in terms such as "... in accordance with the Financial Reporting Standards and the requirements of the applicable Act"

Basis for Modification Paragraph When the Conclusion is Modified (Ref: Para. 86(i)(ii))

A130. An adverse conclusion or a disclaimer of conclusion relating to a specific matter described in the basis for modification paragraph does not justify the omission of a description of other identified matters that would have otherwise required a modification of the practitioner's conclusion. In such cases, the disclosure of such other matters of which the practitioner is aware may be relevant to users of the financial statements.

Signature of the Practitioner (Ref: Para. 86(l))

A131. The report is signed by the practitioner who is the partner/ proprietor in his personal name. Where the firm is appointed as the reviewer, the report is signed in the personal name of the partner/ proprietor and in

¹³ Accounting Standards issued by the ICAI or Accounting Standards notified by the Central Government under the Companies Act, 2013 or Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

the name of the firm. The partner/proprietor signing the review report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the review reports signed by them¹⁴.

Alerting Readers that the Financial Statements are Prepared in Accordance with a Special Purpose Framework (Ref: Para. 88)

A132. The special purpose financial statements may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose financial statements on public record. For avoidance of misunderstanding, it is important that the practitioner alert users of the practitioner's report that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose.

Restriction on Distribution or Use

A133. In addition to the alert to the reader of the practitioner's report that is required by this SRE when the financial statements are prepared using a special purpose framework, the practitioner may consider it appropriate to indicate that the practitioner's report is intended solely for the specific users. Depending on the law or regulation applicable to the entity, this may be achieved by restricting the distribution or use of the practitioner's report. In these circumstances, the paragraph containing the alert about the use of a special purpose framework may be expanded to include these other matters, and the heading modified accordingly.

Other Reporting Responsibilities (Ref: Para. 91)

A134. In some cases, the practitioner may have additional responsibilities under the relevant law or regulation to report on other matters that are supplementary to the practitioner's responsibility under this SRE. For example, the practitioner may be asked to report certain matters if they come to the practitioner's attention during the course of the review of the financial statements. Alternatively, the practitioner may be asked to perform and report on additional specified procedures, or to express a conclusion on specific matters, such as the adequacy of accounting books and records. Such law or regulation may provide guidance on the practitioner's responsibilities with respect to specific additional reporting responsibilities.

A135. In some cases, the relevant law or regulation may require or permit the practitioner to report on these other responsibilities within the practitioner's report on the financial statements. In other cases, the practitioner may be required or permitted to report on them in a separate report.

A136. These other reporting responsibilities are addressed in a separate section of the practitioner's report, to clearly distinguish them from the practitioner's responsibility under this SRE to report on the financial statements. Where relevant, this section may contain sub-heading(s) that describe(s) the content of the other reporting responsibility paragraph(s). In some cases, the additional reporting responsibilities may be addressed in a report that is separate from the practitioner's report provided for the review of the financial statements.

¹⁴ The Council of the ICAI, at its 292nd meeting held in January 2010, decided to require the members of the ICAI to include, in addition to the other requirements relating to signature on the audit report, as prescribed under the relevant Standard on Auditing, the registration number of the firm as allotted by ICAI, in the audit reports signed by them, and ensure that the resolution passed by the company regarding appointment of the statutory auditor of the company under section 224 of the Companies Act, 1956, also contain the registration number of the firm of the auditor(s) with the ICAI. These requirements came into effect from April 1, 2010. Subsequently, the Council of the ICAI, at its 296th meeting held in June 2010, decided to extend the requirement to mention the firm registration number to all reports issued pursuant to any attestation engagement, including certificates, issued by the members as proprietor of/ partner in the said firm. The requirement applies where such firm registration number has been allotted by the ICAI. The Council further decided to make this requirement effective for all attestation reports/ certificates issued on or after 1st October, 2010.

I.644 Auditing Pronouncements

Date of the Practitioner's Report (Ref: Para. 86(k), 92)

A137. The date of the practitioner's report informs the user of the practitioner's report that the practitioner has considered the effect of events and transactions of which the practitioner became aware and that occurred up to that date.

A138. The practitioner's conclusion is provided on the financial statements and the financial statements are the responsibility of management. The practitioner is not in a position to conclude that sufficient appropriate evidence has been obtained until the practitioner is satisfied that all the statements that comprise the financial statements, including the related notes, have been prepared and management has accepted responsibility for them.

A139. In some entities, law or regulation identifies the individuals or bodies (for example, the directors) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In some entities, however, the approval process is not prescribed in law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation may identify the point in the financial statement reporting process at which the review is expected to be complete.

A140. In some entities, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these entities, final approval by shareholders is not necessary for the practitioner to conclude on the financial statements. The date of approval of the financial statements for purposes of this SRE is the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

Practitioner's Report Prescribed by Law or Regulation (Ref: Para. 34-35, 86)

A141. Consistency in the practitioner's report, when the review has been conducted in accordance with this SRE, promotes credibility in the global marketplace by making more readily identifiable those reviews of financial statements that have been conducted in accordance with globally recognized standards. The practitioner's report may refer to this SRE when the differences between the legal or regulatory requirements and this SRE relate only to the layout or wording of the practitioner's report and, at a minimum, the report complies with the requirements of paragraph 86 of this SRE. Accordingly, in such circumstances the practitioner is considered to have complied with the requirements of this SRE, even when the layout and wording used in the practitioner's report are specified by legal or regulatory reporting requirements. Where specific requirements applicable to the entity do not conflict with this SRE, adoption of the layout and wording used in this SRE assists users of the practitioner's report to more readily recognize the practitioner's report as a report on a review of financial statements conducted in accordance with this SRE. Circumstances where law or regulation prescribes the layout or wording of the practitioner's report in terms that are significantly different from the requirements of this SRE are addressed in the requirements of this SRE concerning acceptance of review engagements and continuance of client relationships.

Practitioner's Report for Reviews Conducted in Accordance with Both Relevant Legal or Regulatory Requirements and this SRE (Ref: Para. 86(f))

A142. When, in addition to complying with the requirements of this SRE, the practitioner also complies with other specific relevant legal or regulatory requirements, governing the review engagement, the report may refer to the review having been performed in accordance with both this SRE and such legal or regulatory

requirements for engagements to review financial statements. However, a reference to both this SRE and such legal or regulatory requirements is not appropriate if there is a conflict between the requirements of this SRE and those legal or regulatory requirements that would lead the practitioner to form a different conclusion or not to include an Emphasis of Matter paragraph that, in the particular circumstances, would be required by this SRE. In such a case, the practitioner's report refers only to the relevant standards (either this SRE or the relevant legal or regulatory requirements) in accordance with which the practitioner's report has been prepared.

Illustrative Review Reports (Ref: Para. 86)

A143. Appendix 2 to this SRE contains illustrations of practitioners' reports for a review of financial statements incorporating the reporting requirements of this SRE.

Documentation

Timeliness of Engagement Documentation (Ref: Para. 93)

A144. SQC 1 requires the firm to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis.

Material Modifications vis-a-vis ISRE 2400 (Revised), "Engagements to Review Historical Financial Statements"

There are no material modifications in SRE 2400 (Revised) vis-à-vis ISRE 2400 (Revised), "Engagements to Review Historical Financial Statements"

Appendix 1

(Ref: Para. A55)

Illustrative Engagement Letter for an Engagement to Review Historical Financial Statements

The following is an example of an engagement letter for a review of general purpose financial statements (prepared in accordance with the applicable fair presentation Financial Reporting Framework), which illustrates the relevant requirements and guidance contained in this SRE. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SRE. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the review of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring reviews. It may be appropriate to seek legal advice that any proposed letter is suitable.

To the appropriate representative of management or those charged with governance of ABC Company:¹⁵

[The objective and scope of the review]

You¹⁶ have requested that we review the general purpose financial statements of ABC Company, which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this review engagement by means of this letter.

Our review will be conducted with the objective of expressing our conclusion on the financial statements. Our conclusion, if unmodified, will be in the form "Based on our review, nothing has come to our attention that

¹⁵ The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement. It is important to refer to the appropriate persons — see paragraph 36 of this SRE.

¹⁶ Throughout this letter, references to "you," "we," "us," "management," "those charged with governance" and "practitioner" would be used or amended as appropriate in the circumstances.

I.646 Auditing Pronouncements

causes us to believe that these financial statements do not give a true and fair view of (or do not present fairly, *in all material respects*,) the financial position of the company as at [date] and of its financial performance and cash flows for the year then ended in accordance with [indicate the applicable financial reporting framework].”

[The practitioner’s responsibilities]

We will conduct our review in accordance with Standard on Review Engagements (SRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. SRE 2400 also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SRE 2400(Revised) is a limited assurance engagement. We will perform procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluate the evidence obtained. We will also perform additional procedures if we become aware of matters that cause us to believe the financial statements as a whole may be materially misstated. These procedures are performed to enable us to express our conclusion on the financial statements in accordance with SRE 2400(Revised). The procedures selected will depend on what we consider necessary applying our professional judgment, based on our understanding of ABC Company and its environment, and our understanding of the applicable financial reporting framework and its application in the industry context.

A review is not an audit of the financial statements, therefore:

- (a) There is a commensurate higher risk than there would be in an audit, that any material misstatements that exist in the financial statements reviewed may not be revealed by the review, even though the review is properly performed in accordance with SRE 2400 (Revised).
- (b) In expressing our conclusion from the review of the financial statements, our report on the financial statements will expressly disclaim any audit opinion on the financial statements.

[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example, it is assumed that the practitioner has not determined that the law or regulation prescribes those responsibilities in appropriate terms; the descriptions in paragraph 30(b) of this SRE are therefore used).]

Our review will be conducted on the basis that [management and, where appropriate, those charged with governance]¹⁷ acknowledge and understand that they have the responsibility:

- (a) For the preparation of financial statements that give a true and fair view in accordance with [indicate the applicable financial reporting framework];¹⁸
- (b) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
 - (i) Access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation and other matters;
 - (ii) Additional information that we may request from management for the purpose of the review; and

¹⁷ Use terminology as appropriate in the circumstances.

¹⁸ Or, if appropriate, “For preparation and fair presentation of the financial statements in accordance with [indicate the applicable financial reporting framework]”

- (iii) Unrestricted access to persons within ABC Company from whom we determine it necessary to obtain evidence.

As part of our review, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the review.

We look forward to full cooperation from your staff during our review.

[Other relevant information]

[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the practitioner's report.]

The form and content of our report may need to be amended in the light of our findings obtained from the review.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our review of the financial statements including our respective responsibilities.

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation¹⁹)
Membership Number

Place of Signature

Date

Acknowledged on behalf of ABC Company by

(Signature)

Name and Designation

Date

¹⁹ Partner or proprietor, as the case may be.

Illustrative Practitioners' Review Reports

Review Reports on General Purpose Financial Statements

Illustrative Review Reports with Unmodified Conclusions

Illustration 1: A practitioner's report on financial statements prepared in accordance with a fair presentation framework designed to meet the common financial information needs of a wide range of users (for example, Accounting Standards referred to in the Companies Act, 2013).

Illustrative Review Reports with Modified Conclusions

Illustration 2: A practitioner's report containing a qualified conclusion due to an apparent material misstatement of the financial statements. Financial statements prepared in accordance with a compliance framework designed to meet the common information needs of a wide range of users. (Financial statements prepared using a compliance framework)

Illustration 3: A practitioner's report containing a qualified conclusion due to the practitioner's inability to obtain sufficient appropriate evidence. (Financial statements prepared using a fair presentation framework)

Illustration 4: A practitioner's report containing an adverse conclusion due to material misstatement of the financial statements. (Financial statements prepared using a fair presentation framework)

Illustration 5: A practitioner's report containing a disclaimer of conclusion due to the practitioner's inability to obtain sufficient appropriate evidence about multiple elements of the financial statements resulting in inability to complete the review. (Financial statements prepared using a fair presentation framework)

Review Reports on Special Purpose Financial Statements

Illustration 6: A practitioner's report on financial statements prepared in accordance with the financial reporting provisions of a contract (for purposes of this illustration, a compliance framework).

Illustration 7: A practitioner's report on a single financial statement prepared in accordance with the cash receipts and disbursements basis of accounting (for purposes of this illustration, a fair presentation framework).

Illustration 1

Circumstances include the following:

- Review of a complete set of financial statements.
- The financial statements are prepared for a general purpose by management of the entity under the Companies Act, 2013 financial reporting framework, designed to achieve fair presentation
- The terms of the review engagement reflect the description of management's responsibility for the financial statements in paragraph 30(b) of this SRE.
- In addition to the review of the financial statements, the practitioner has other reporting responsibilities under the law.

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

Report on the Financial Statements²⁰

We have reviewed the accompanying financial statements of ABC Company, which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's²¹ Responsibility for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the Accounting Standards referred to in the Companies Act, 2013 (the Act) and other accounting principles generally accepted in India²², and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with Standard on Review Engagements (SRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not give a true and fair view of (or *present fairly, in all material respects,*) the financial position of ABC Company as at March 31, 20XX, and of its financial performance and cash flows for the year then ended, in accordance with the Accounting Standards referred to in the Companies Act, 2013 and other accounting principles generally accepted in India.

²⁰ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²¹ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

²² Where management is responsible for the preparation and fair presentation of financial statements, this may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Accounting Standards referred to in the Companies Act, 2013 (the Act) and other accounting principles generally accepted in India, and for such ..."

I.650 Auditing Pronouncements

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the practitioner's report will vary depending on the nature of the practitioner's other reporting responsibilities.]

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation²³)
Membership Number

Place of Signature

Date

Illustration 2

Circumstances include the following:

- Review of a complete set of financial statements required by law or regulation.
- The financial statements are prepared for a general purpose by management of the entity in accordance with the Financial Reporting Framework (DEF Law) (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the review engagement reflect the description of management's responsibility for the financial statements in paragraph 30(b) of this SRE.
- Based on the review, inventories are misstated. The misstatement is material but not pervasive to the financial statements.
- In addition to the review of the financial statements, the practitioner has other reporting responsibilities under the law.

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

Report on the Financial Statements²⁴

We have reviewed the accompanying financial statements of ABC Company, which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's²⁵ Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with DEF Law, and for such internal control as management determines is necessary to enable the preparation of financial

²³ Partner or proprietor, as the case may be.

²⁴ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²⁵ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with Standard on Review Engagements (SRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Basis for Qualified Conclusion

The company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the requirements of the Financial Reporting Framework (DEF Law). The company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of Rs. XXX would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net income and shareholders' equity would have been reduced by Rs. XXX, XXX and XXX, respectively.

Qualified Conclusion

Based on our review, except for the effects of the matter described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements of ABC Company are not prepared, in all material respects, in accordance with the Financial Reporting Framework (DEF Law).

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the practitioner's report will vary depending on the nature of the practitioner's other reporting responsibilities.]

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation²⁶)
Membership Number

Place of Signature
Date

²⁶ Partner or proprietor, as the case may be.

Illustration 3

Circumstances include the following:

- Review of a complete set of general purpose financial statements prepared by management of the entity under the Companies Act, 2013 financial reporting framework, designed to achieve fair presentation.
- The terms of the review engagement reflect the description of management's responsibility for the financial statements in paragraph 30(b) of this SRE.
- The practitioner was unable to obtain sufficient appropriate evidence regarding an investment in a foreign affiliate. The possible effects of the inability to obtain sufficient appropriate evidence are deemed to be material but not pervasive to the financial statements.
- The practitioner does not have other reporting responsibilities under the law in addition to the review of the consolidated financial statements.

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

We have reviewed the accompanying financial statements of ABC Company, which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's²⁷ Responsibility for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the Accounting Standards referred to in the Companies Act, 2013 (the Act) and other accounting principles generally accepted in India,²⁸ and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with Standard on Review Engagements (SRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Basis for Qualified Conclusion

ABC Company's investment in DEF Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. XXX on the Balance Sheet as at March 31, 20XX, and ABC's

²⁷ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

²⁸ Where management is responsible for the preparation and fair presentation of financial statements, this may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Accounting Standards referred to in Companies Act, 2013 (the Act) and other accounting principles generally accepted in India, and for such ..."

share of DEF 's net income of Rs. XXX is included in ABC's income for the year then ended. We were unable to obtain access to the relevant financial information of DEF concerning the carrying amount of ABC's investment in DEF as at March 31, 20XX and ABC's share of DEF's net income for the year. Consequently, we were unable to perform the procedures we considered necessary.

Qualified Conclusion

Based on our review, except for the possible effects of the matter described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view of (or do not *present fairly, in all material respects*) the financial position of ABC Company as at March 31, 20XX, and of its financial performance and cash flows for the year then ended in accordance with the Accounting Standards referred to in Companies Act, 2013 and other accounting principles generally accepted in India.

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation²⁹)
Membership Number

Place of Signature

Date

Illustration 4

Circumstances include the following:

- Review of consolidated general purpose financial statements prepared by management of the parent under the accounting principles generally accepted in India (as required for compliance with SEBI's regulatory requirements), designed to achieve fair presentation .
- The terms of the review engagement reflect the description of management's responsibility for the financial statements in paragraph 30(b) of this SRE.
- The financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the financial statements. The effects of the misstatement on the financial statements have not been determined because it was not practicable to do so.
- The practitioner does not have other reporting responsibilities under the law in addition to the review of the consolidated financial statements.

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

We have reviewed the accompanying consolidated financial statements of ABC Company, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss

²⁹ Partner or proprietor, as the case may be.

and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's³⁰ Responsibility for the Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view in accordance with the accounting principles generally accepted in India,³¹ and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying consolidated financial statements. We conducted our review in accordance with Standard on Review Engagements (SRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the consolidated financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of consolidated financial statements in accordance with SRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing. Accordingly, we do not express an audit opinion on these consolidated financial statements.

Basis for Adverse Conclusion

As explained in Note X to the Financial Statements, the company has not consolidated the financial statements of subsidiary DEF Company it acquired during 20XX because the financial statements of this subsidiary company have not been prepared by its management. This investment is therefore accounted for on a cost basis. Under the accounting principles generally accepted in India, the subsidiary should have been consolidated because it is controlled by the company. Had DEF been consolidated, many elements in the accompanying financial statements would have been materially affected.

Adverse Conclusion

Based on our review, due to the significance of the matter discussed in the Basis for Adverse Conclusion paragraph, the consolidated financial statements do not give a true and fair view of (or do not present fairly) the financial position of ABC Company and its subsidiaries as at March 31, 20XX, and of their financial performance and cash flows for the year then ended in accordance with the accounting principles generally accepted in India.

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

³⁰ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

³¹ Where management is responsible for the preparation and fair presentation of financial statements, this may read: "Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with the accounting principles generally accepted in India, and for such ..."

Signature
(Name of Member signing the Review Report)
(Designation³²)
Membership Number

Place of Signature

Date

Illustration 5

Circumstances include the following:

- Review of a complete set of general purpose financial statements prepared by management of the entity under the Companies Act, 2013 financial reporting framework, designed to achieve fair presentation.
- The terms of the review engagement reflect the description of management's responsibility for the financial statements in paragraph 30(b) of this SRE.
- The practitioner was unable to form a conclusion on the financial statements, due to inability to obtain sufficient appropriate evidence about multiple elements of the financial statements, and the practitioner believes the effect is material and pervasive to the financial statements. Specifically, the practitioner was unable to obtain evidence about the entity's physical inventory and accounts receivable.

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

We were engaged to review the accompanying financial statements of ABC Company, which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's³³ Responsibility for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the Accounting Standards referred to in the Companies Act, 2013 (the Act) and other accounting principles generally accepted in India,³⁴ and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. Because of the matter(s) described in the Basis for Disclaimer of Conclusion paragraph, however, we were not able to obtain sufficient appropriate evidence as a basis for expressing a conclusion on the financial statements.

Basis for Disclaimer of Conclusion

Management did not conduct a count of physical inventory on hand at the end of the year. We were unable to perform the procedures we considered necessary concerning the inventory quantities held at March 31, 20XX, which are stated at Rs. XXX in the Balance Sheet at March 31, 20XX.

³² Partner or proprietor, as the case may be.

³³ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

³⁴ Where management is responsible for the preparation and fair presentation of financial statements, this may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Accounting Standards referred to in the Companies Act, 2013 and other accounting principles generally accepted in India, and for such ..."

I.656 Auditing Pronouncements

In addition, the introduction of a new computerized accounts receivable system in January 20XX resulted in numerous errors in accounts receivable and inventory. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors.

As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the Statement of Profit and Loss and Cash Flow Statement.

Disclaimer of Conclusion

Due to the significance of the matters described in the Basis for Disclaimer of Conclusion paragraph, we were unable to obtain sufficient appropriate evidence to form a conclusion on the accompanying financial statements. Accordingly, we do not express a conclusion on these financial statements.

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation³⁵)
Membership Number

Place of Signature

Date

Illustration 6

Circumstances include the following:

- The financial statements have been prepared by management of the entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework), to comply with the provisions of the contract. Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a compliance framework.
- The terms of the review engagement reflect the description of management's responsibility for the financial statements in paragraph 30(b) of this SRE.
- Distribution or use of the practitioner's report is restricted.

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

We have reviewed the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management of ABC Company based on the financial reporting provisions of Section Z of the contract dated January 1, 20XX between ABC Company and DEF Company ("the contract").

³⁵ Partner or proprietor, as the case may be.

Management's³⁶ Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the financial reporting provisions of Section Z of the contract, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with Standard on Review Engagements (SRE) 2400(Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SRE 2400(Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that these financial statements are not prepared, in all material respects, in accordance with the financial reporting provisions of Section Z of the contract.

Basis of Accounting, and Restriction on Distribution and Use

Without modifying our conclusion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist ABC Company to comply with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for ABC Company and DEF Company and should not be distributed to or used by parties other than ABC Company or DEF Company.

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation³⁷)
Membership Number

Place of Signature

Date

³⁶ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

³⁷ Partner or proprietor, as the case may be.

Illustration 7

Circumstances include the following:

- Review of a statement of cash receipts and disbursements.
- The financial statement has been prepared by management of the entity in accordance with the cash receipts and disbursements basis of accounting to respond to a request for cash flow information received from a creditor. The basis of accounting applied to prepare the financial statement has been agreed between the entity and the creditor.
- The applicable financial reporting framework is a fair presentation framework designed to meet the financial information needs of specific users.
- The practitioner has determined that it is appropriate to use the phrase “presents fairly, in all material respects,” in the practitioner’s conclusion.
- The terms of the review engagement reflect the description of management’s responsibility for the financial statement in paragraph 30(b) of this SRE.
- Distribution or use of the practitioner’s report is not restricted.

INDEPENDENT PRACTITIONER’S REVIEW REPORT

[Appropriate Addressee]

We have reviewed the accompanying statement of cash receipts and disbursements of ABC Company for the year ended March 31, 20XX, and a summary of significant accounting policies and other explanatory information (together “the financial statement”). The financial statement has been prepared by management of ABC Company using the cash receipts and disbursements basis of accounting described in Note X to the financial statement.

Management’s³⁸ Responsibility for the Financial Statement

Management is responsible for the preparation and fair presentation of this financial statement in accordance with the cash receipts and disbursements basis of accounting described in Note X, and for such internal control as management determines is necessary to enable the preparation of the financial statement that is free from material misstatement, whether due to fraud or error.

Practitioner’s Responsibility

Our responsibility is to express a conclusion on the accompanying financial statement. We conducted our review in accordance with Standard on Review Engagements (SRE) 2400 (Revised), Engagements to Review Historical Financial Statements. SRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statement is not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing. Accordingly, we do not express an audit opinion on this financial statement.

³⁸ Or other term that is appropriate in the context of the legal framework applicable to the particular entity.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the financial statement does not present fairly, in all material respects, (or does not give a true and fair view of) the cash receipts and disbursements of ABC Company for the year ended March 31, 20XX in accordance with the cash receipts and disbursements basis of accounting described in Note X.

Basis of Accounting

Without modifying our conclusion, we draw attention to Note X to the financial statement, which describes the basis of accounting. The financial statement is prepared to provide information to DEF Creditor. As a result, the financial statement may not be suitable for another purpose.

For XYZ and Co.,
Chartered Accountants
Firm's Registration Number

Signature
(Name of Member signing the Review Report)
(Designation³⁹)
Membership Number

Place of Signature

Date

³⁹ Partner or proprietor, as the case may be.

SRE 2410*

**Review of Interim Financial Information Performed
by the Independent Auditor of the Entity**
*(Effective for reviews of interim financial information for
periods beginning on or after April 1, 2010)*

Introduction

1. The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client, and on the form and content of the report. The term "auditor" is used throughout this SRE, not because the auditor is performing an audit function but because the scope of this SRE is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity.

2. For purposes of this SRE, interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework¹ and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

3. **The auditor who is engaged to perform a review of interim financial information should perform the review in accordance with this SRE.** Through performing the audit of the annual financial statements, the auditor obtains an understanding of the entity and its environment, including its internal control. When the auditor is engaged to review the interim financial information, this understanding is updated through inquiries made in the course of the review, and assists the auditor in focusing the inquiries to be made and the analytical and other review procedures to be applied. A practitioner who is engaged to perform a review of interim financial information, and who is not the auditor of the entity, performs the review in accordance with SRE 2400 (Revised), "Engagements to Review Financial Statements." As the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal control, as the auditor of the entity, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review.

3a. This SRE is directed towards a review of interim financial information by an entity's auditor. However, it is to be applied, adapted as necessary in the circumstances, when an entity's auditor undertakes an engagement to review historical financial information other than interim financial information of an audit client.

General Principles of a Review of Interim Financial Information

4. **The auditor should comply with the ethical requirements relevant to the audit of the annual financial statements of the entity.** These ethical requirements govern the auditor's professional responsibilities in the following areas: independence, integrity, objectivity, professional competence and due care, confidentiality, professional behavior, and technical standards.

* Published in May, 2010 issue of the Journal.

¹ For example, Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

5. **The auditor should implement quality control procedures that are applicable to the individual engagement.** The elements of quality control that are relevant to an individual engagement include leadership responsibilities for quality on the engagement, ethical requirements, acceptance and continuance of client relationships and specific engagements, assignment of engagement teams, engagement performance, and monitoring.

6. **The auditor should plan and perform the review with an attitude of professional skepticism, recognizing that circumstances may exist that cause the interim financial information to require a material adjustment for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.** An attitude of professional skepticism means that the auditor makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by management of the entity.

Objective of an Engagement to Review Interim Financial Information

7. The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.

8. The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with Standards on Auditing (SAs). A review of interim financial information does not provide a basis for expressing an opinion whether the financial information gives a true and fair view, or is presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

9. A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

Agreeing the Terms of the Engagement

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

11. The agreed terms of the engagement are ordinarily recorded in an engagement letter. Such a communication helps to avoid misunderstandings regarding the nature of the engagement and, in particular, the objective and scope of the review, management's responsibilities, the extent of the auditor's responsibilities, the assurance obtained, and the nature and form of the report. The communication ordinarily covers the following matters:

- The objective of a review of interim financial information.
- The scope of the review.
- Management's responsibility for the interim financial information.
- Management's responsibility for establishing and maintaining effective internal control relevant to the preparation of interim financial information.
- Management's responsibility for making all financial records and related information available to the auditor

I.662 Auditing Pronouncements

- Management's agreement to provide written representations to the auditor to confirm representations made orally during the review, as well as representations that are implicit in the entity's records.
- The anticipated form and content of the report to be issued, including the identity of the addressee of the report.
- Management's agreement that where any document containing interim financial information indicates that the interim financial information has been reviewed by the entity's auditor, the review report will also be included in the document.

An illustrative engagement letter is set out in Appendix 1 to this SRE. The terms of engagement to review interim financial information can also be combined with the terms of engagement to audit the annual financial statements.

Procedures for a Review of Interim Financial Information

Understanding the Entity and its Environment, Including its Internal Control

12. The auditor should have an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information, sufficient to plan and conduct the engagement so as to be able to:

- (a) Identify the types of potential material misstatement and consider the likelihood of their occurrence; and**
- (b) Select the inquiries, analytical and other review procedures that will provide the auditor with a basis for reporting whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.**

13. As required by SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment," the auditor who has audited the entity's financial statements for one or more annual periods has obtained an understanding of the entity and its environment, including its internal control, as it relates to the preparation of annual financial information that was sufficient to conduct the audit. In planning a review of interim financial information, the auditor updates this understanding. The auditor also obtains a sufficient understanding of internal control as it relates to the preparation of interim financial information as it may differ from internal control as it relates to annual financial information.

14. The auditor uses the understanding of the entity and its environment, including its internal control, to determine the inquiries to be made and the analytical and other review procedures to be applied, and to identify the particular events, transactions or assertions to which inquiries may be directed or analytical or other review procedures applied.

15. The procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following:

- Reading the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.
- Considering any significant risks, including the risk of management override of controls, that were identified in the audit of the prior year's financial statements.
- Reading the most recent annual and comparable prior period interim financial information.

- Considering materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.
- Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.
- Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
- Considering the results of any audit procedures performed with respect to the current year's financial statements.
- Considering the results of any internal audit performed and the subsequent actions taken by management.
- Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
- Inquiring of management about the effect of changes in the entity's business activities.
- Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
- Inquiring of management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.

16. The auditor determines the nature of the review procedures, if any, to be performed for components and, where applicable, communicates these matters to other auditors involved in the review. Factors to be considered include the materiality of, and risk of misstatement in, the interim financial information of components, and the auditor's understanding of the extent to which internal control over the preparation of such information is centralized or decentralized.

17. In order to plan and conduct a review of interim financial information, a recently appointed auditor, who has not yet performed an audit of the annual financial statements in accordance with SAs, should obtain an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information.

18. This understanding enables the auditor to focus the inquiries made, and the analytical and other review procedures applied in performing a review of interim financial information in accordance with this SRE. As part of obtaining this understanding, the auditor ordinarily makes inquiries of the predecessor auditor and, peruses the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. In doing so, the auditor considers the nature of any corrected misstatements, and any uncorrected misstatements aggregated by the predecessor auditor, any significant risks, including the risk of management override of controls, and significant accounting and any reporting matters that may be of continuing significance, such as material weaknesses in internal control.

Inquiries, Analytical and Other Review Procedures

19. The auditor should make inquiries, primarily of persons responsible for financial and accounting matters, and perform analytical and other review procedures to enable the auditor to conclude whether, on the basis of the procedures performed, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

20. A review ordinarily does not require tests of the accounting records through inspection, observation or confirmation. Procedures for performing a review of interim financial information are ordinarily limited to making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures, rather than corroborating information obtained concerning significant accounting matters relating to the interim financial information. The auditor's understanding of the entity and its environment, including its internal control, the results of the risk assessments relating to the preceding audit and the auditor's consideration of materiality as it relates to the interim financial information, affects the nature and extent of the inquiries made, and analytical and other review procedures applied.

21. The auditor ordinarily performs the following procedures:

- Reading the minutes of the meetings of shareholders, those charged with governance, and other appropriate committees to identify matters that may affect the interim financial information, and inquiring about matters dealt with at meetings for which minutes are not available that may affect the interim financial information.
- Considering the effect, if any, of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements, at the time of the previous audit or reviews.
- Communicating, where appropriate, with other auditors who are performing a review of the interim financial information of the reporting entity's significant components.
- Inquiring of members of management responsible for financial and accounting matters, and others as appropriate about the following:
 - ◆ Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework.
 - ◆ Whether there have been any changes in accounting principles or in the methods of applying them.
 - ◆ Whether any new transactions have necessitated the application of a new accounting principle.
 - ◆ Whether the interim financial information contains any known uncorrected misstatements.
 - ◆ Unusual or complex situations that may have affected the interim financial information, such as a business combination or disposal of a segment of the business.
 - ◆ Significant assumptions that are relevant to the fair value measurement or disclosures and management's intention and ability to carry out specific courses of action on behalf of the entity.
 - ◆ Whether related party transactions have been appropriately accounted for and disclosed in the interim financial information.
 - ◆ Significant changes in commitments and contractual obligations.
 - ◆ Significant changes in contingent liabilities including litigation or claims.
 - ◆ Compliance with debt covenants.
 - ◆ Matters about which questions have arisen in the course of applying the review procedures.
 - ◆ Significant transactions occurring in the last several days of the interim period or the first several days of the next interim period.
 - ◆ Knowledge of any fraud or suspected fraud affecting the entity involving:
 - Management;
 - Employees who have significant roles in internal control; or

- Others where the fraud could have a material effect on the interim financial information.
 - ◆ Knowledge of any allegations of fraud, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.
 - ◆ Knowledge of any actual or possible noncompliance with laws and regulations that could have a material effect on the interim financial information.
 - Applying analytical procedures to the interim financial information designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement in the interim financial information. Analytical procedures may include ratio analysis and statistical techniques such as trend analysis or regression analysis and may be performed manually or with the use of computer-assisted techniques. Appendix 2 to this SRE contains examples of analytical procedures the auditor may consider when performing a review of interim financial information.
 - Reading the interim financial information, and considering whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.
22. The auditor may perform many of the review procedures before or simultaneously with the entity's preparation of the interim financial information. For example, it may be practicable to update the understanding of the entity and its environment, including its internal control, and begin reading applicable minutes before the end of the interim period. Performing some of the review procedures earlier in the interim period also permits early identification and consideration of significant accounting matters affecting the interim financial information.
23. The auditor performing the review of interim financial information is also engaged to perform an audit of the annual financial statements of the entity. For convenience and efficiency, the auditor may decide to perform certain audit procedures concurrently with the review of interim financial information. For example, information gained from reading the minutes of meetings of the board of directors in connection with the review of the interim financial information also may be used for the annual audit. The auditor may also decide to perform, at the time of the interim review, auditing procedures that would need to be performed for the purpose of the audit of the annual financial statements, for example, performing audit procedures on significant or unusual transactions that occurred during the period, such as business combinations, restructurings, or significant revenue transactions.
24. A review of interim financial information ordinarily does not require corroborating the inquiries about litigation or claims. It is, therefore, ordinarily not necessary to send an inquiry letter to the entity's lawyer. Direct communication with the entity's lawyer with respect to litigation or claims may, however, be appropriate if a matter comes to the auditor's attention that causes the auditor to question whether the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework, and the auditor believes the entity's lawyer may have pertinent information.
25. **The auditor should obtain evidence that the interim financial information agrees or reconciles with the underlying accounting records.** The auditor may obtain evidence that the interim financial information agrees or reconciles with the underlying accounting records by tracing the interim financial information to:
- (a) The accounting records, such as the general ledger, or a consolidating schedule that agrees or reconciles with the accounting records; and
 - (b) Other supporting data in the entity's records as necessary.
26. **The auditor should inquire whether management has identified all events up to the date of the review report that may require adjustment to or disclosure in the interim financial information.** It is not

necessary for the auditor to perform other procedures to identify events occurring after the date of the review report.

27. The auditor should inquire whether management has changed its assessment of the entity's ability to continue as a going concern. When, as a result of this inquiry or other review procedures, the auditor becomes aware of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:

- (a) **Inquire of management as to its plans for future actions based on its going concern assessment, the feasibility of these plans, and whether management believes that the outcome of these plans will improve the situation; and**
- (b) **Consider the adequacy of the disclosure about such matters in the interim financial information.**

28. Events or conditions which may cast significant doubt on the entity's ability to continue as a going concern may have existed at the date of the annual financial statements or may be identified as a result of inquiries of management or in the course of performing other review procedures. When such events or conditions come to the auditor's attention, the auditor inquires of management as to its plans for future action, such as its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. The auditor also inquires as to the feasibility of management's plans and whether management believes that the outcome of these plans will improve the situation. However, it is not ordinarily necessary for the auditor to corroborate the feasibility of management's plans and whether the outcome of these plans will improve the situation.

29. When a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made for the interim financial information to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should make additional inquiries or perform other procedures to enable the auditor to express a conclusion in the review report. For example, if the auditor's review procedures lead the auditor to question whether a significant sales transaction is recorded in accordance with the applicable financial reporting framework, the auditor performs additional procedures sufficient to resolve the auditor's questions, such as discussing the terms of the transaction with senior marketing and accounting personnel, or reading the sales contract.

Evaluation of Misstatements

30. The auditor should evaluate, individually and in the aggregate, whether uncorrected misstatements that have come to the auditor's attention are material to the interim financial information.

31. A review of interim financial information, in contrast to an audit engagement, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. However, misstatements which come to the auditor's attention, including inadequate disclosures, are evaluated individually and in the aggregate to determine whether a material adjustment is required to be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.

32. The auditor exercises professional judgment in evaluating the materiality of any misstatements that the entity has not corrected. The auditor considers matters such as the nature, cause and amount of the misstatements, whether the misstatements originated in the preceding year or interim period of the current year, and the potential effect of the misstatements on future interim or annual periods.

33. The auditor may designate an amount below which misstatements need not be aggregated, because the auditor expects that the aggregation of such amounts clearly would not have a material effect on the interim financial information. In so doing, the auditor considers the fact that the determination of materiality involves quantitative as well as qualitative considerations, and that misstatements of a relatively small amount could nevertheless have a material effect on the interim financial information.

Management Representations

34. **The auditor should obtain written representation from management that:**

- (a) **It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud and error;**
- (b) **The interim financial information is prepared and presented in accordance with the applicable financial reporting framework;**
- (c) **It believes the effect of those uncorrected misstatements aggregated by the auditor during the review are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole. A summary of such items is included in or attached to the written representations;**
- (d) **It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity;**
- (e) **It has disclosed to the auditor the results of its assessment of the risks that the interim financial information may be materially misstated as a result of fraud²;**
- (f) **It has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects are to be considered when preparing the interim financial information; and**
- (g) **It has disclosed to the auditor all significant events that have occurred subsequent to the balance sheet date and through to the date of the review report that may require adjustment to or disclosure in the interim financial information.**

35. The auditor obtains additional representations as are appropriate related to matters specific to the entity's business or industry. An illustrative management representation letter is set out in Appendix 3 to this SRE.

Auditor's Responsibility for Accompanying Information

36. **The auditor should read the other information that accompanies the interim financial information to consider whether any such information is materially inconsistent with the interim financial information.** If the auditor identifies a material inconsistency, the auditor considers whether the interim financial information or the other information needs to be amended. If an amendment is necessary in the interim financial information and management refuses to make the amendment, the auditor considers the implications for the review report. If an amendment is necessary in the other information and management refuses to make the amendment, the auditor considers including in the review report an additional paragraph describing the material inconsistency, or taking other actions, such as withholding the issuance of the review report or withdrawing from the engagement. For example, management may present alternative measures of earnings that more positively portray results of operations than the interim financial information, and such alternative measures are given excessive prominence, are not clearly defined, or not clearly reconciled to the interim financial information such that they are confusing and potentially misleading.

² Refer SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

37. If a matter comes to the auditor's attention that causes the auditor to believe that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management. While reading the other information for the purpose of identifying material inconsistencies, an apparent material misstatement of fact may come to the auditor's attention (i.e., information, not related to matters appearing in the interim financial information, that is incorrectly stated or presented). When discussing the matter with the entity's management, the auditor considers the validity of the other information and management's responses to the auditor's inquiries, whether valid differences of judgment or opinion exist and whether to request management to consult with a qualified third party to resolve the apparent misstatement of fact. If an amendment is necessary to correct a material misstatement of fact and management refuses to make the amendment, the auditor considers taking further action as appropriate, such as notifying those charged with governance and obtaining legal advice.

Communication

38. When, as a result of performing the review of interim financial information, a matter comes to the auditor's attention that causes the auditor to believe that it is necessary to make a material adjustment to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should communicate this matter as soon as practicable to the appropriate level of management.

39. When, in the auditor's judgment, management does not respond appropriately within a reasonable period of time, the auditor should inform those charged with governance. The communication is made as soon as practicable, either orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as the nature, sensitivity and significance of the matter to be communicated and the timing of such communications. If the information is communicated orally, the auditor documents the communication.

40. When, in the auditor's judgment, those charged with governance do not respond appropriately within a reasonable period of time, the auditor should consider:

- (a) **Whether to modify the report; or**
- (b) **The possibility of withdrawing from the engagement; and**
- (c) **The possibility of resigning from the appointment to audit the annual financial statements.**

41. When, as a result of performing the review of interim financial information, a matter comes to the auditor's attention that causes the auditor to believe in the existence of fraud or noncompliance by the entity with laws and regulations the auditor should communicate the matter as soon as practicable to the appropriate level of management. The determination of which level of management is the appropriate one is affected by the likelihood of collusion or the involvement of a member of management. The auditor also considers the need to report such matters to those charged with governance and considers the implication for the review.

42. The auditor should communicate relevant matters of governance interest arising from the review of interim financial information to those charged with governance. As a result of performing the review of the interim financial information, the auditor may become aware of matters that in the opinion of the auditor are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. The auditor communicates such matters to those charged with governance.

Reporting the Nature, Extent and Results of the Review of Interim Financial Information

43. The auditor should issue a written report that contains the following:

- (a) **An appropriate title.**

- (b) An addressee, as required by the circumstances of the engagement.
- (c) Identification of the interim financial information reviewed, including identification of the title of each of the statements contained in the complete or condensed set of financial statements and the date and period covered by the interim financial information.
- (d) If the interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a statement that management is responsible for the preparation and fair presentation of the interim financial information in accordance with the applicable financial reporting framework.
- (e) In other circumstances, a statement that management is responsible for the preparation and presentation of the interim financial information in accordance with the applicable financial reporting framework.
- (f) A statement that the auditor is responsible for expressing a conclusion on the interim financial information based on the review.
- (g) A statement that the review of the interim financial information was conducted in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity," and a statement that that such a review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.
- (h) A statement that a review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable the auditor to obtain assurance that the auditor would become aware of all significant matters that might be identified in an audit and that accordingly no audit opinion is expressed.
- (i) If the interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information does not give a true and fair view, or does not present fairly, in all material respects, in accordance with the applicable financial reporting framework (including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards³ applicable in India).
- (j) In other circumstances, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework (including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards applicable in India).
- (k) The date of the report.
- (l) Place of Signature.

³ Accounting Standards issued by the Institute of Chartered Accountants of India or Accounting Standards notified by the Central Government as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India, as may be applicable.

I.670 Auditing Pronouncements

- (m) **The auditor's signature and membership number assigned by the Institute of Chartered Accountants of India (ICAI).**
- (n) **The Firm's registration number of the member of the Institute, wherever applicable, as allotted by ICAI.**

Illustrative review reports are set out in Appendix 4 to this SRE.

44. In some jurisdictions, law or regulation governing the review of interim financial information may prescribe wording for the auditor's conclusion that is different from the wording described in paragraph 43(i) or (j). Although the auditor may be obliged to use the prescribed wording, the auditor's responsibilities as described in this SRE for coming to the conclusion remain the same.

Departure from the Applicable Financial Reporting Framework

45. **The auditor should express a qualified or adverse conclusion when a matter has come to the auditor's attention that causes the auditor to believe that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.**

46. If matters have come to the auditor's attention that cause the auditor to believe that the interim financial information is or may be materially affected by a departure from the applicable financial reporting framework, and management does not correct the interim financial information, the auditor modifies the review report. The modification describes the nature of the departure and, if practicable, states the effects on the interim financial information. If the information that the auditor believes is necessary for adequate disclosure is not included in the interim financial information, the auditor modifies the review report and, if practicable, includes the necessary information in the review report. The modification to the review report is ordinarily accomplished by adding an explanatory paragraph to the review report, and qualifying the conclusion. Illustrative review reports with a qualified conclusion are set out in Appendix 5 to this SRE.

47. When the effect of the departure is so material and pervasive to the interim financial information that the auditor concludes a qualified conclusion is not adequate to disclose the misleading or incomplete nature of the interim financial information, the auditor expresses an adverse conclusion. Illustrative review reports with an adverse conclusion are set out in Appendix 7 to this SRE.

Limitation on Scope

48. A limitation on scope ordinarily prevents the auditor from completing the review.

49. **When the auditor is unable to complete the review, the auditor should communicate, in writing, to the appropriate level of management and to those charged with governance the reason why the review cannot be completed, and consider whether it is appropriate to issue a report.**

Limitation on Scope Imposed by Management

50. The auditor does not accept an engagement to review the interim financial information if the auditor's preliminary knowledge of the engagement circumstances indicates that the auditor would be unable to complete the review because there will be a limitation on the scope of the auditor's review imposed by management of the entity.

51. If, after accepting the engagement, management imposes a limitation on the scope of the review, the auditor requests the removal of that limitation. If management refuses to do so, the auditor is unable to complete the review and express a conclusion. In such cases, the auditor communicates, in writing, to the appropriate level of management and those charged with governance the reason why the review cannot be completed. Nevertheless, if a matter comes to the auditor's attention that causes the auditor to believe that a material adjustment to the interim financial information is necessary for it to be prepared, in all material

respects, in accordance with the applicable financial reporting framework, the auditor communicates such matters in accordance with the guidance in paragraphs 38-40.

52. The auditor also considers the legal and regulatory responsibilities, including whether there is a requirement for the auditor to issue a report. If there is such a requirement, the auditor disclaims a conclusion, and provides in the review report the reason why the review cannot be completed. However, if a matter comes to the auditor's attention that causes the auditor to believe that a material adjustment to the interim financial information is necessary for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor also communicates such a matter in the report.

Other Limitations on Scope

53. A limitation on scope may occur due to circumstances other than a limitation on scope imposed by management. In such circumstances, the auditor is ordinarily unable to complete the review and express a conclusion and is guided by paragraphs 51-52. There may be, however, some rare circumstances where the limitation on the scope of the auditor's work is clearly confined to one or more specific matters that, while material, are not in the auditor's judgment pervasive to the interim financial information. In such circumstances, the auditor modifies the review report by indicating that, except for the matter which is described in an explanatory paragraph to the review report, the review was conducted in accordance with this SRE, and by qualifying the conclusion. Illustrative review reports with a qualified conclusion are set out in Appendix 6 to this SRE.

54. The auditor may have expressed a qualified opinion on the audit of the latest annual financial statements because of a limitation on the scope of that audit. The auditor considers whether that limitation on scope still exists and, if so, the implications for the review report.

Going Concern and Significant Uncertainties

55. In certain circumstances, an emphasis of matter paragraph may be added to a review report, without affecting the auditor's conclusion, to highlight a matter that is included in a note to the interim financial information that more extensively discusses the matter. The paragraph would preferably be included after the conclusion paragraph and ordinarily refers to the fact that the conclusion is not qualified in this respect.

56. If adequate disclosure is made in the interim financial information, the auditor should add an emphasis of matter paragraph to the review report to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.

57. The auditor may have modified a prior audit or review report by adding an emphasis of matter paragraph to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern. If the material uncertainty still exists and adequate disclosure is made in the interim financial information, the auditor modifies the review report on the current interim financial information by adding a paragraph to highlight the continued material uncertainty.

58. If, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information the auditor modifies the review report by adding an emphasis of matter paragraph.

59. If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty.

I.672 Auditing Pronouncements

60. **The auditor should consider modifying the review report by adding a paragraph to highlight a significant uncertainty (other than a going concern problem) that came to the auditor's attention, the resolution of which is dependent upon future events and which may affect the interim financial information.**

Other Considerations

61. The terms of the engagement include management's agreement that where any document containing interim financial information indicates that such information has been reviewed by the entity's auditor, the review report will also be included in the document. If management has not included the review report in the document, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances⁴.

62. If the auditor has issued a modified review report and management issues the interim financial information without including the modified review report in the document containing the interim financial information, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances, and the possibility of resigning from the appointment to audit the annual financial statements⁵.

63. Interim financial information consisting of a condensed set of financial statements does not necessarily include all the information that would be included in a complete set of financial statements, but may rather present an explanation of the events and changes that are significant to an understanding of the changes in the state of affairs and performance of the entity since the annual reporting date. This is because it is presumed that the users of the interim financial information will have access to the latest audited financial statements, such as is the case with listed entities. In other circumstances, the auditor discusses with management the need for such interim financial information to include a statement that it is to be read in conjunction with the latest audited financial statements. In the absence of such a statement, the auditor considers whether, without a reference to the latest audited financial statements, the interim financial information is misleading in the circumstances, and the implications for the review report.

Documentation

64. **The auditor should prepare review documentation that is sufficient and appropriate to provide a basis for the auditor's conclusion and to provide evidence that the review was performed in accordance with this SRE and applicable legal and regulatory requirements.** The documentation enables an experienced auditor having no previous connection with the engagement to understand the nature, timing and extent of the inquiries made, and analytical and other review procedures applied, information obtained, and any significant matters considered during the performance of the review, including the disposition of such matters.

⁴ The Council of the ICAI, at its 308th meeting held in August 2011, considered an issue relating to difficulties being faced by the members of the Institute in compliance with paragraphs 61 and 62 of the SRE 2410 raised by the Auditing and Assurance Standards Board of the Institute. On a consideration of the matter, the Council was of the opinion that paragraphs 61 and 62 did not envisage the auditor to take steps to ensure that on every occasion when the review results were published by the management, it also published the review report therewith. The responsibility of the auditor was upto issuance of the review report on the results, at most till the time the interim results, along with the review report, were filed by the company with the concerned stock exchange. Further, since such filing led to the concerned interim results and the review report thereon becoming available in the public domain, the same would be construed as sufficient compliance by the auditor with the requirements of paragraphs 61 and 62 of SRE 2410. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

⁵ *ibid*

Effective Date

65. This SRE is effective for reviews of interim financial information for periods beginning on or after April 1, 2010.

Material Modifications *vis-a-vis* ISRE 2410, “Review of Interim Financial Information Performed by the Independent Auditor of the Entity”

Additions

Paragraph 43 of ISRE 2410 deals with the basic elements of the written report of an auditor on the Review of Interim Financial Information, which also includes the location in the country or jurisdiction where the auditor practices. Since in India, Revised Standard on Auditing (SA) 700 requires the auditor to mention the “Place of Signature”, i.e., name of specific location, which is ordinarily the city where the review report is signed, in his report, the requirement of mentioning the location in the country or jurisdiction where the auditor practices has been replaced with the requirement to mention the place of signature in the auditor’s report.

Deletion

Paragraph 18 of ISRE 2410 deals with the procedures for obtaining the understanding of the entity and its environment for conducting the review of the interim financial information. These procedures also include the review of the predecessor auditor’s documentation for the preceding annual audit, and for any prior interim periods in the current year that have been reviewed by the predecessor auditor. Since in India, Clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of the Code of Ethics, the requirement of reviewing the predecessor auditor’s documentation has been replaced with the requirement of perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements.

Appendix 1

Example of an Engagement Letter for a Review of Interim Financial Information

The following letter is to be used as a guide in conjunction with the consideration outlined in paragraph 10 of this SRE and will need to be adapted according to individual requirements and circumstances.

To the Board of Directors of ABC Company Ltd. (or the appropriate representative of senior management)

We are providing this letter to confirm our understanding of the terms and objectives of our engagement to review the entity’s interim balance sheet as at September 30, 20X1 and the related statement of profit & loss and cash flows for the six-month period then ended.

Our review will be conducted in accordance with Standard on Review Engagements (SRE) 2410, “Review of Interim Financial Information Performed by the Independent Auditor of the Entity” issued by the Institute of Chartered Accountants of India (ICAI) with the objective of providing us with a basis for reporting whether anything has come to our attention that causes us to believe that the interim financial information is not prepared, in all material respects, in accordance with the [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting when the financial reporting framework used is not Financial Reporting Standards⁶ applicable in India]. Such a review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and

⁶ See footnote 4.

I.674 Auditing Pronouncements

other review procedures and does not, ordinarily, require corroboration of the information obtained. The scope of a review of interim financial information is substantially less than the scope of an audit conducted in accordance with Standards on Auditing whose objective is the expression of an opinion regarding the financial statements and, accordingly, we shall express no such opinion.

We expect to report on the interim financial information as follows:

[Include text of sample report.]

Responsibility for the interim financial information, including adequate disclosure, is that of management of the entity. This includes designing, implementing and maintaining internal control relevant to the preparation and presentation of interim financial information that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances. As part of our review, we will request written representations from management concerning assertions made in connection with the review. We will also request that where any document containing interim financial information indicates that the interim financial information has been reviewed, our report will also be included in the document.

A review of interim financial information does not provide assurance that we will become aware of all significant matters that might be identified in an audit. Further, our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our review.

[Insert additional information here regarding fee arrangements and billings, as appropriate.]

This letter will be effective for future years unless it is terminated, amended or superseded (if applicable).

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our review of the interim financial information including our respective responsibilities.

XYZ & Co.
Chartered Accountants
Firm's Registration Number
.....

.....
(Signature)
(Name of the Member)
(Designation⁷)

Date:

Place:

Acknowledged on behalf of ABC Company by

.....

(Signature)

Name and Designation

Date

⁷ Partner or proprietor, as the case may be.

Appendix 2

Analytical Procedures the Auditor May Consider When Performing a Review of Interim Financial Information

Examples of analytical procedures the auditor may consider when performing a review of interim financial information include the following:

- Comparing the interim financial information with the interim financial information of the immediately preceding interim period, with the interim financial information of the corresponding interim period of the preceding financial year, with the interim financial information that was expected by management for the current period, and with the most recent audited annual financial statements.
- Comparing current interim financial information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes to pretax income in the current interim financial information with corresponding information in (a) budgets, using expected rates, and (b) financial information for prior periods).
- Comparing current interim financial information with relevant non-financial information.
- Comparing the recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and applying relationships that are reasonably expected to exist based on the auditor's understanding of the entity and of the industry in which the entity operates.
- Comparing ratios and indicators for the current interim period with those of entities in the same industry.
- Comparing relationships among elements in the current interim financial information with corresponding relationships in the interim financial information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.
- Comparing disaggregated data. The following are examples of how data may be disaggregated:
 - ◆ By period, for example, revenue or expense items disaggregated into quarterly, monthly, or weekly amounts.
 - ◆ By product line or source of revenue.
 - ◆ By location, for example, by component.
 - ◆ By attributes of the transaction, for example, revenue generated by designers, architects, or craftsmen.
 - ◆ By several attributes of the transaction, for example, sales by product and month.

Example of a Management Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from entity to entity and from one interim period to the next.

(Entity Letterhead)

(To Auditor)

(Date)

Opening paragraphs if interim financial information comprises condensed financial statements:

This representation letter is provided in connection with your review of the condensed balance sheet of ABC Entity as of June 30, 20X1 and the related condensed statements of profit & loss and cash flows for the three-month period then ended for the purposes of expressing a conclusion whether anything has come to your attention that causes you to believe that the interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards⁸ applicable in India].

We acknowledge our responsibility for the preparation and presentation of the interim financial information in accordance with [indicate applicable financial reporting framework].

Opening paragraphs if interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation:

This representation letter is provided in connection with your review of the balance sheet of ABC Entity as of June 30, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended and a summary of the significant accounting policies and other explanatory notes for the purposes of expressing a conclusion whether anything has come to your attention that causes you to believe that the interim financial information does not give a true and fair view of (*or “does not present fairly, in all material respects,”*) the state of affairs of ABC Entity as at June 30, 20X1, and of its results of operations and its cash flows in accordance with [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards⁹ applicable in India].

We acknowledge our responsibility for the fair presentation of the interim financial information in accordance with [indicate applicable financial reporting framework].

We confirm, to the best of our knowledge and belief, the following representations:

- The interim financial information referred to above has been prepared and presented in accordance with [indicate applicable financial reporting framework].
- We have made available to you all books of account and supporting documentation, and all minutes of meetings of shareholders and the board of directors (namely those held on [insert applicable dates]).
- There are no material transactions that have not been properly recorded in the accounting records underlying the interim financial information.
- There has been no known actual or possible noncompliance with laws and regulations that could have a material effect on the interim financial information in the event of noncompliance.

⁸ See footnote 4.

⁹ See footnote 4.

- We acknowledge responsibility for the design and implementation of internal control to prevent and detect fraud and error.
- We have disclosed to you all significant facts relating to any known frauds or suspected frauds that may have affected the entity.
- We have disclosed to you the results of our assessment of the risk that the interim financial information may be materially misstated as the result of fraud.
- We believe the effects of uncorrected misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole.
- We confirm the completeness of the information provided to you regarding the identification of related parties.
- The following have been properly recorded and, when appropriate, adequately disclosed in the interim financial information:
 - ◆ Related party transactions, including sales, purchases, loans, transfers, leasing arrangements and guarantees, and amounts receivable from or payable to related parties;
 - ◆ Guarantees, whether written or oral, under which the entity is contingently liable; and
 - ◆ Agreements and options to buy back assets previously sold.
- The presentation and disclosure of the fair value measurements of assets and liabilities are in accordance with [indicate applicable financial reporting framework]. The assumptions used reflect our intent and ability to carry specific courses of action on behalf of the entity, where relevant to the fair value measurements or disclosure.
- We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities reflected in the interim financial information.
- We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of realizable value.
- The entity has satisfactory title to all assets and there are no liens or encumbrances on the entity's assets.
- We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent.
- [Add any additional representations related to new accounting standards that are being implemented for the first time and consider any additional representations required by a new Standard on Auditing that are relevant to interim financial information.]

To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that may require adjustment to or disclosure in the aforementioned interim financial information.

(Senior Executive Officer)

(Senior Financial Officer)

Appendix 4

Examples of Review Reports on Interim Financial Information

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of June 30, 20X1 and the related statements of profit & loss and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity"¹⁰. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (*or "does not present fairly, in all material respects,"*) the state of affairs of the entity as at June 30, 20X1, and of its results of operations and its cash flows for the three month period then ended in accordance with [applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards¹¹ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number

Auditor's Signature

(Name of Member signing the Audit Report)

(Designation¹²)

Membership Number

Place of Signature

Date

¹⁰ In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

¹¹ See footnote 4.

¹² Partner or proprietor, as the case may be.

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of June 30, 20X1 and the related [condensed] statements of profit & loss and cash flows for the three-month period then ended. Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity"¹³. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with [applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards¹⁴ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation¹⁵)
Membership Number

Place of Signature

Date

¹³ In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

¹⁴ See footnote 4.

¹⁵ Partner or proprietor, as the case may be.

Appendix 5

Examples of Review Reports with a Qualified Conclusion for a Departure from the Applicable Financial Reporting Framework

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of June 30, 20X1 and the related statements of profit & loss and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity"¹⁶. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalized to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalized at June 30, 20X1, property would be increased by ₹_____, long-term debt by ₹_____, and net income and earnings per share would be increased (decreased) by ₹_____, ₹_____, ₹_____, and ₹_____, respectively for the three-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or "does not present fairly, in all material respects,") the state of affairs of the entity as at June 30, 20X1, and of its results of operations and its cash flows for the three month period then ended in accordance with [indicate applicable financial reporting framework, including the reference to the

¹⁶ In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards¹⁷ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation¹⁸)
Membership Number

Place of Signature

Date

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of June 30, 20X1 and the related [condensed] statements of profit & loss and cash flows for the three-month period then ended. Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity"¹⁹. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalized to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalized at June 30, 20X1, property would be increased by ₹_____, long-term debt by ₹_____, and net income and

¹⁷ See footnote 4.

¹⁸ Partner or proprietor, as the case may be.

¹⁹ In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

I.682 Auditing Pronouncements

earnings per share would be increased (decreased) by ₹_____, ₹_____, ₹_____, and ₹_____, respectively for the three-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards²⁰ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation²¹)
Membership Number

Place of Signature

Date

Appendix 6

Examples of Review Reports with a Qualified Conclusion for a Limitation on Scope Not Imposed By Management

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(ii))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of June 30, 20X1 and the related statements of profit & loss and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

Except as explained in the following paragraph, we conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent

²⁰ See footnote 4.

²¹ Partner or proprietor, as the case may be.

Auditor of the Entity”²². A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totaling Rs. _____ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above and the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or “does not present fairly, in all material respects,”) the state of affairs of the entity as at June 30, 20X1, and of its Results of Operations and its cash flows for the three-month period then ended in accordance with [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards²³ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm’s Registration Number
Auditor’s Signature
(Name of Member signing the Audit Report)
(Designation²⁴)
Membership Number

Place of Signature

Date

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of June 30, 20X1 and the related [condensed] statements of profit & loss and cash flows for the three-month period then ended. Management is responsible for the preparation and presentation of this interim financial information in

²² In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: “We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity.” The remainder of the report should be adapted as necessary in the circumstances.

²³ See footnote 4.

²⁴ Partner or proprietor, as the case may be.

I.684 Auditing Pronouncements

accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

Except as explained in the following paragraph, we conducted our review in accordance with Standards on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Auditor of the Entity"²⁵. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totaling Rs. _____ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above and the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards²⁶ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation²⁷)
Membership Number

Place of Signature

Date

²⁵ In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

²⁶ See footnote 4.

²⁷ Partner or proprietor, as the case may be.

Appendix 7

Examples of Review Reports with an Adverse Conclusion for a Departure from the Applicable Financial Reporting Framework

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of June 30, 20X1 and the related statements of profit & loss and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Auditor of the Entity"²⁸. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Adverse Conclusion

Commencing this period, management of the entity ceased to consolidate the financial statements of its subsidiary companies since management considers consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including a reference to the relevant jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards²⁹ applicable in India]. Had consolidated financial statements been prepared, virtually every account in the interim financial information would have been materially different.

Adverse Conclusion

Our review indicates that, because the entity's investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, this interim financial information does not give a true and fair view of (or "does not present fairly, in all material respects,") the state of affairs of the entity as at June 30, 20X1, and of its results of operations and its cash flows for the three-month period then ended in accordance with [indicate applicable financial reporting framework, including a reference to the relevant

²⁸ In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

²⁹ See footnote 4.

jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards³⁰ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation³¹)
Membership Number

Place of Signature

Date

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of June 30, 20X1 and the related [condensed] statements of profit & loss and cash flows for the three-month period then ended. Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independence Auditor of the Entity"³². A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Adverse Conclusion

Commencing this period, management of the entity ceased to consolidate the financial statements of its subsidiary companies since management considers consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including the reference to the relevant jurisdiction of the financial reporting

³⁰ See footnote 4.

³¹ Partner or proprietor, as the case may be.

³² In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

framework when the financial reporting framework used is not Financial Reporting Standards³³ applicable in India]. Had consolidated financial statements been prepared, virtually every account in the interim financial information would have been materially different.

Adverse Conclusion

Our review indicates that, because the entity's investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, this interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction of the financial reporting framework when the financial reporting framework used is not Financial Reporting Standards³⁴ applicable in India].

For ABC and Co.,
Chartered Accountants
Firm's Registration Number
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation³⁵)
Membership Number

Place of Signature

Date

³³ See footnote 4.

³⁴ See footnote 4.

³⁵ Partner or proprietor, as the case may be.

SAE 3400
The Examination of
Prospective Financial Information
(Effective in relation to reports on
projections/forecasts issued on or after April 1, 2007)

Introduction

1. The purpose of this Standard on Assurance Engagement (SAE) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This SAE does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination¹. Further, the principles laid down in the other Standards on Auditing, issued by the Institute of Chartered Accountants of India, should be used by the auditor, to the extent practicable, in applying this SAE.

2. In an engagement to examine prospective financial information, the auditor² should obtain sufficient appropriate evidence as to whether:

- (a) management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;
- (b) the prospective financial information is properly prepared on the basis of the assumptions;
- (c) the prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and
- (d) the prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.

3. "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its

¹ The guidance provided in this Standard is in line with the provisions of clause (3) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 [as amended by the Chartered Accountants (Amendment) Act, 2006]. This clause provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct "if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast." As per the opinion of the Council while finalising the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts at its 100th meeting held on 22nd through 24th July 1982, a chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report **the sources of information, the basis of forecasts** and also the **major assumptions** made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts. The Council has further opined that the same opinion would also apply to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as the auditor does not vouch for the accuracy of the projection. (*emphasis added*)

² The term "auditor" is used throughout this SAE when describing services involving examination of prospective financial information. Such reference is not intended to imply that a member performing such services need necessarily be the statutory auditor of the entity's financial statements.

preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection, or a combination of both, for example, a one year forecast plus a five year projection.

4. A “*forecast*” means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

5. A “*projection*” means prospective financial information prepared on the basis of:

- (a) hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- (b) a mixture of best-estimate and hypothetical assumptions.

Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a “what-if” scenario).

6. Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:

- (a) as an internal management tool, for example, to assist in evaluating a possible capital investment; or
- (b) for the distribution/submission to third parties in, for example:
 - a prospectus to provide potential investors with information about future expectations.
 - an annual report to provide information to shareholders, regulatory bodies and other interested parties.
 - a document, for example, cash flow forecasts, for the information of lenders.

7. Management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the sources of information, the basis of forecasts and the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes.

The Auditor’s Assurance Regarding Prospective Financial Information

8. Prospective financial information relates to events and actions that have not yet occurred and might not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

9. Further, given the types of evidence available in assessing the assumptions on which the prospective financial information is based, it may be difficult for the auditor to obtain a level of satisfaction sufficient to provide a positive expression of opinion that the assumptions are free of material misstatement. Consequently, in this SAE, when reporting on the reasonableness of management’s assumptions, the auditor provides only a moderate level of assurance.

Acceptance of Engagement

10. Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

I.690 Auditing Pronouncements

- the intended use of the information;
- whether the information will be for general or limited distribution;
- the nature of the assumptions, that is, whether they are best-estimates or hypothetical assumptions;
- the elements to be included in the information; and
- the period covered by the information.

11. The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

12. In accordance with SA 210, “Terms of Audit Engagement”, it is necessary that the auditor and the client should agree on the terms of the engagement. It is in the interest of both client and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters in paragraph 10 and set out the management’s responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

Knowledge of the Business

13. The auditor should obtain a sufficient level of knowledge of the business to be able to evaluate whether all significant assumptions required for the preparation of the prospective financial information have been identified. The auditor would also need to become familiar with the entity’s process for preparing prospective financial information, for example, by considering:

- (a) The internal controls over the system used to prepare prospective financial information and the expertise and experience of those persons preparing the prospective financial information.
- (b) The nature of the documentation prepared by the entity supporting management’s assumptions.
- (c) The extent to which statistical, mathematical and computer-assisted techniques are used.
- (d) The methods used to develop and apply assumptions.
- (e) The accuracy of prospective financial information prepared in prior periods, if any, and the reasons for any significant variances therein.

14. The auditor should consider the extent to which reliance on the entity’s historical financial information is justified. The auditor requires knowledge of the entity’s historical financial information to assess whether the prospective financial information has been prepared on a basis consistent with the historical financial information and to provide a historical yardstick for considering management’s assumptions. The auditor will need to establish, for example, whether relevant historical information was audited or reviewed and whether acceptable accounting principles were used in its preparation.

15. If the audit or review report on prior period historical financial information was other than a clean report³ or if the entity is in a start-up/expansion phase, the auditor would consider the relevant facts and the effect on the examination of the prospective financial information.

Period Covered

16. The auditor should consider the period of time covered by the prospective financial information. Since assumptions become more speculative as the length of the period covered increases, as that period lengthens, the ability of management to make best-estimate assumptions decreases. The period

³ Alternatively known as the unmodified report in terms of the Standard on Auditing (SA) 700, “The Auditor’s Report on Financial Statements”.

would not extend beyond the time for which management has a reasonable basis for the assumptions. The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by the prospective financial information:

- (a) The operating cycle, for example, in the case of a major construction project undertaken by a construction company, the time required to complete the project may dictate the period covered.
- (b) The degree of reliability of assumptions, for example, if the entity is introducing a new product, the prospective period covered could be short and broken into small segments, such as weeks or months. Alternatively, if for example, the entity's sole business is owning a property under long-term lease, a relatively long prospective period might be reasonable.
- (c) The needs of users, for example, prospective financial information may be prepared in connection with an application for a loan for the period of time required to generate sufficient funds for repayment. Alternatively, the information may be prepared for investors in connection with the issue of securities to illustrate the intended use of the proceeds in the subsequent period.

Examination Procedures

17. When determining the nature, timing and extent of examination procedures, the auditor should consider matters such as:

- (a) the knowledge obtained during any previous engagements;**
- (b) management's competence regarding the preparation of prospective financial information;**
- (c) the likelihood of material misstatement;**
- (d) the extent to which the prospective financial information is affected by the management's judgment;**
- (e) the sources of information considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions;**
- (f) the stability of entity's business; and**
- (g) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information.**

18. The auditor would assess the source and reliability of the evidence supporting management's best-estimate assumptions. Sufficient appropriate evidence supporting such assumptions would be obtained from internal and external sources including consideration of the assumptions in the light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity. Examples of external sources are government publications, industry publications, economic forecast, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, the economic substance and viability of the entity and/or transaction or project of the entity, reputation of management responsible for assumptions underlying the prospective financial information, wage agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans, etc.

19. The auditor would consider whether, when hypothetical assumptions are used, all significant implications of such assumptions have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production.

I.692 Auditing Pronouncements

20. The auditor would need to be satisfied that the hypothetical assumptions are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.

21. The auditor will need to be satisfied that the prospective financial information is properly prepared from management's assumptions by, for example, making checks such as recomputation and reviewing internal consistency, that is, the actions management intends to take are compatible with each other and there are no inconsistencies in the determination of the amounts that are based on common variables such as interest rates.

22. The auditor would focus on the extent to which those areas that are particularly sensitive to variation will have a material effect on the results shown in the prospective financial information. This will influence the extent to which the auditor will seek appropriate evidence. It will also influence the auditor's evaluation of the appropriateness and adequacy of disclosure.

23. When engaged to examine one or more elements of prospective financial information, such as an individual financial statement, it is important that the auditor considers the interrelationship of other components in the financial statements.

24. When any elapsed portion of the current period is included in the prospective financial information, the auditor would consider the extent to which procedures need to be applied to the historical information. Procedures will vary depending on the circumstances, for example, how much of the prospective period has elapsed.

25. The auditor should obtain written representations from management regarding the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information. The management is also responsible for identification and disclosure of uncontrollable factors, outstanding litigations, commitments, or any other material factors that are likely to affect the prospective financial information.

Presentation and Disclosure

26. When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, the auditor will need to consider whether:

- (a) the presentation of prospective financial information is informative and not misleading;
- (b) the accounting policies are clearly disclosed in the notes to the prospective financial information;
- (c) the assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;
- (d) the date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;
- (e) the basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and

- (f) there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements and whether reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.

Documentation

27. The auditor should document matters, which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out in accordance with this SAE. The working papers will include the sources of information, basis of forecasts and the assumptions made in arriving the forecasts, hypothetical assumptions, evidence supporting the assumptions, management representations regarding the intended use and distribution of the information, completeness of material assumptions, management's acceptance of its responsibility for the information, audit plan, the nature, timing and extent of examination procedures performed, and, in case the auditor expresses a modified opinion or withdraws from the engagement, the reasons forming the basis of such decision.

Report on Examination of Prospective Financial Information

28. The report by an auditor on an examination of prospective financial information should contain the following:

- (a) Title;
- (b) Addressee;
- (c) Identification of the prospective financial information;
- (d) Reference to the Standards on Auditing applicable to the examination of prospective financial information;
- (e) Statement that management is responsible for the prospective financial information including the underlying assumptions;
- (f) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;
- (g) Statement that the examination procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the forecast or projection;
- (h) Statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;
- (i) Opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;
- (j) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;
- (k) Date of report (which should be the date procedures have been completed);
- (l) Place of signature; and
- (m) Signature.

29. Such a report would:

- State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention, which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.

I.694 Auditing Pronouncements

- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- State that:
 - Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range; and
 - In the case of a projection, the prospective financial information has been prepared for (intended use), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial information should not be used for purposes other than the abovementioned intended use.

30. The following is an example of an extract from an unmodified report on a projection:

We have examined the projection of _____ (project) _____ (name of the entity) for the period from _____ to _____ as given in⁴ _____ to the Prospective Financial Information from page _____ to _____ in accordance with Standard on Assurance Engagement 3400, "The Examination of Prospective Financial Information", issued by the Institute of Chartered Accountants of India. The preparation and presentation of the projection including the underlying assumptions, set out in note _____ to _____ to the prospective financial information, is the responsibility of the Management and has been approved by the Board of Directors⁵ of the company. Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information. Our responsibility does not include verification of the accuracy of the projections. Therefore, we do not vouch for the accuracy of the same.

This projection has been prepared for (describe purpose). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

We have carried out our examination of the prospective financial information on a test basis. Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that _____ (state or refer to the hypothetical assumptions).

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note _____ to the Prospective Financial Information and on a consistent basis in accordance with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

A complete illustrative format of an unmodified report on a projection is given in **Appendix 1**.

31. The following is an example of an extract from an unmodified report on a forecast:

⁴ Provide suitable identification, such as by reference to page numbers or by identifying the individual schedule.

⁵ Other corresponding approving authority in the case of entities other than companies.

We have examined the forecast of _____ (*project*) of the _____ (*name of the entity*) for the period from _____ to _____ in accordance with the Standard on Assurance Engagements (SAE) 3400, "The Examination of Prospective Financial Information", issued by the Institute of Chartered Accountants of India. The preparation and presentation of the forecast including the underlying assumptions, set out in Note _____ to the Prospective Financial Information is the responsibility of the management and has been approved by the Board of Directors of the Company. The sources of information are set out in Annexure _____ to the prospective financial information. Our responsibility is to examine the evidence supporting the forecast. Our responsibility does not include verification of the accuracy of the forecasts. Therefore, we do not vouch for the accuracy of the same.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions as set out in Note ____ and on consistent basis with historical financial statements, using appropriate accounting principles.

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

A complete illustrative format of an unmodified report on a forecast is given in **Appendix 2**.

32. When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate. An example would be where financial information fails to disclose adequately the consequences of any assumptions, which are highly sensitive.

33. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion setting out the reasons in the report on the prospective financial information, or withdraw from the engagement.

34. When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

Effective Date

35. This SAE is effective in relation to reports on projections/forecasts, issued on or after April 1, 2007. However, earlier application of the Standard is encouraged.

Compatibility with International Standard on Assurance Engagement (ISAE) 3400

Except for the matters noted below, the basic principles and essential procedures of this SAE and International Standard on Assurance Engagement (ISAE) 3400 "The Examination of Prospective Financial Information", are consistent in all material respects:

- (a) SAE precludes the auditor from expressing positive assurance regarding the assumptions as it may tantamount to vouching for the accuracy of the forecast/projection/hypothetical assumptions. Whereas, the ISAE 3400 permits the auditor to express positive assurance when in his judgment an appropriate level of satisfaction has been obtained.

- (b) The sub points in paragraph 17 (corresponding to paragraph 17 of the ISAE 3400) have been rearranged. Sub point (e) has been elucidated for the sake of better understanding of the readers. The sub points (f) and (g) have been added in the SAE as additional factors to be considered by the auditor.
- (c) In paragraph 20 of the SAE, the phrase “although evidence supporting hypothetical assumptions need not be obtained” has been deleted since it is felt that such a phrase is inconsistent with the necessity for the auditor to obtain evidence to support his conclusions.
- (d) In paragraph 26 (corresponding to paragraph 26 of the ISAE 3400), the term “professional standards” has been changed to “professional pronouncements” since pronouncements would include standards as well as other relevant documents, such as Guidance Notes, announcement(s), issued by the ICAI.
- (e) In line with requirement of SA 700, “The Auditor’s Report on Financial Statements” this SAE requires the auditor to include a scope section in the examination report to explain the nature and extent of the auditor’s work. ISAE 3400 does not contain an equivalent requirement.
- (f) SAE specifically provides for the documentation required to be done by the auditor in regard to any engagement of examination of prospective financial information. However, ISAE 3400 does not contain such explicit provision.

Appendix 1

**Illustrative Format of
an Unmodified Report on a Projection**

***Report on Examination of
Prospective Financial Information***

To the ...(addressee).....

We have examined the projection of _____ (project) _____ (name of the entity) for the period from _____ to _____ as given in⁶ _____ to the Prospective Financial Information from page __ to __ in accordance with Standard on Assurance Engagement 3400, “The Examination of Prospective Financial Information”, issued by the Institute of Chartered Accountants of India. The preparation and presentation of the projection including the underlying assumptions, set out in note _____ to _____ to the prospective financial information, is the responsibility of the Management and has been approved by the Board of Directors⁷ of the company. Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information. Our responsibility does not include verification of projections. Therefore, we do not vouch for the accuracy of the same.

This projection has been prepared for _____ (intended use). The projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management’s actions that are not necessarily expected to occur. Consequently, users are cautioned that this projection may not be appropriate for purposes other than that described above.

We have carried out our examination of the prospective financial information on a test basis. Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us

⁶ Provide suitable identification, such as by reference to page numbers or by identifying the individual schedule.

⁷ Other corresponding approving authority in the case of entities other than companies.

to believe that these assumptions do not provide a reasonable basis for the projection, assuming that _____ (state or refer to the hypothetical assumptions).

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note _____ to the Prospective Financial Information and on a consistent basis with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

For ABC & Co.,
Chartered Accountants

Signature
(Name of the member signing the report)

(Designation)⁸

Date :

Place of Signature :

Membership Number

Appendix 2

Illustrative Format of an Unmodified Report on a Forecast

Report on Examination of Prospective Financial Information

To the(addressee).....

We have examined the forecast of _____ (project) _____ of the _____ (name of the entity) for the period from ___ to ___ as given⁹ in ___ to ___ of the prospective financial information in accordance with Standard on Assurance Engagement __, The Examination of Prospective Financial Information, issued by the Institute of Chartered Accountants of India. The preparation and presentation of the forecast including the underlying assumptions, set out in Note _____ to the Prospective Financial Information, is the responsibility of the management and has been approved by the Board of Directors of the company¹⁰. The sources of information are set out in Annexure _____ to the prospective financial information. Our responsibility is to examine the evidence supporting the forecast. Our responsibility does not include verification of the forecasts. Therefore, we do not vouch for the accuracy of the same.

This forecast has been prepared for _____ (intended use). The forecast has been prepared using a set of assumptions as set out in Note _____ to the prospective financial information.

We have carried out our examination of the prospective financial information on a test basis.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention, which causes us to believe that assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast, read with the notes thereon, is properly prepared on the basis of the assumptions as set out in Note _____ and on a consistent basis with the historical financial statements, using appropriate accounting principles.

⁸ Partner or proprietor, as the case may be.

⁹ Provide suitable identification, such as by reference to page numbers or by identifying the individual schedule.

¹⁰ Other corresponding approving authority in the case of entities other than companies.

I.698 Auditing Pronouncements

Actual results are likely to be different from the forecast since anticipated events might not occur as expected and the variation might be material.

For ABC & Co.,
Chartered Accountants

Signature
(Name of the member signing the report)
(Designation)¹¹
Membership Number

Place of Signature:

Date:

¹¹ Partner or proprietor, as the case may be.

SAE 3402

Assurance Reports on Controls At a Service Organisation

(Effective for service auditors' assurance reports covering periods ending on or after April 1, 2011)

Introduction

Scope of this SAE

1. This Standard on Assurance Engagements (SAE) deals with assurance engagements undertaken by a professional accountant in public practice¹ to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements SA 402², in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402. (Ref: Para. A1)
2. The "Framework for Assurance Engagements" states that an assurance engagement may be a "reasonable assurance" engagement or a "limited assurance" engagement; that an assurance engagement may be either an "assertion-based" engagement or a "direct reporting" engagement; and, that the assurance conclusion for an assertion-based engagement can be worded either in terms of the responsible party's assertion or directly in terms of the subject matter and the criteria.³ This SAE only deals with assertion-based engagements that convey reasonable assurance, with the assurance conclusion worded directly in terms of the subject matter and the criteria⁴.
3. This SAE applies only when the service organization is responsible for, or otherwise able to make an assertion about, the suitable design of controls. This SAE does not deal with assurance engagements:
 - (a) To report only on whether controls at a service organization operated as described, or
 - (b) To report only on controls at a service organization other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting (for example, controls that affect user entities' production or quality control). (Ref: Para. A2)
4. In addition to issuing an assurance report on controls, a service auditor may also be engaged to provide reports such as the following, which are not dealt with in this SAE:
 - (a) A report on a user entity's transactions or balances maintained by a service organization; or
 - (b) An agreed-upon procedures report on controls at a service organization.

Relationship with Other Professional Pronouncements

5. Framework for Assurance Engagements provides requirements in relation to such topics as

¹ As per the Framework for Assurance Engagements, issued by the Institute of Chartered Accountants of India, the term "professional accountant in public practice (practitioner)" refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

² SA 402, "Audit Considerations Relating to an Entity Using a Service Organization".

³ Framework for Assurance Engagements, paragraphs 9, 10 and 56.

⁴ Paragraphs 13 and 53(k) of this SAE.

I.700 Auditing Pronouncements

engagement acceptance, planning, evidence, and documentation that apply to all assurance engagements, including engagements in accordance with this SAE. This SAE expands on how such requirements are to be applied in a reasonable assurance engagement to report on controls at a service organization. The Framework for Assurance Engagements, which also defines and describes the elements and objectives of an assurance engagement, provides the context for understanding this SAE.

6. Compliance with Framework for Assurance Engagements requires, among other things, that the service auditor comply with the Code of Ethics of the Institute of Chartered Accountants of India, and implement quality control procedures that are applicable to the individual engagement⁵.

Effective Date

7. This SAE is effective for service auditors' assurance reports covering periods ending on or after April 1, 2011.

Objectives

8. The objectives of the service auditor are:

- (a) To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:
 - (i) The service organization's description of its system fairly presents the system as designed and implemented throughout the specified period (or in the case of a type 1 report, as at a specified date);
 - (ii) The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period (or in the case of a type 1 report, as at a specified date);
 - (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved throughout the specified period.
- (b) To report on the matters in (a) above in accordance with the service auditor's findings.

Definitions

9. For purposes of this SAE, the following terms have the meanings attributed below:

- (a) *Carve-out method* – Method of dealing with the services provided by a subservice organization, whereby the service organization's description of its system includes the nature of the services provided by a subservice organization, but that subservice organization's relevant control objectives and related controls are excluded from the service organization's description of its system and from the scope of the service auditor's engagement. The service organization's description of its system and the scope of the service auditor's engagement include controls at the service organization to monitor the effectiveness of controls at the subservice organization, which may include the service organization's review of an assurance report on controls at the subservice organization.
- (b) *Complementary user entity controls* – Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives stated in the service organization's description of its system, are identified in that description.
- (c) *Control objective* – The aim or purpose of a particular aspect of controls. Control objectives relate to risks that controls seek to mitigate.
- (d) *Controls at the service organization* – Controls over the achievement of a control objective that is

⁵ Framework for Assurance Engagements, paragraph 4. Members attention is also drawn to ISAE 3000, paragraphs 4 and 6.

covered by the service auditor's assurance report. (Ref: Para. A3)

- (e) *Controls at a subservice organization* – Controls at a subservice organization to provide reasonable assurance about the achievement of a control objective.
- (f) *Criteria* – Benchmarks used to evaluate or measure a subject matter including, where relevant, benchmarks for presentation and disclosure.
- (g) *Inclusive method* – Method of dealing with the services provided by a subservice organization, whereby the service organization's description of its system includes the nature of the services provided by a subservice organization, and that subservice organization's relevant control objectives and related controls are included in the service organization's description of its system and in the scope of the service auditor's engagement. (Ref: Para. A4)
- (h) *Internal audit function* – An appraisal activity established or provided as a service to the service organization. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.
- (i) *Internal auditors* – Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.
- (j) *Report on the description and design of controls at a service organization (referred to in this SAE as a "type 1 report")* – A report that comprises:
 - (i) The service organization's description of its system;
 - (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:
 - a. The description fairly presents the service organization's system as designed and implemented as at the specified date;
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date; and
 - (iii) A service auditor's assurance report that conveys reasonable assurance about the matters in (ii)a.-b. above.
- (k) *Report on the description, design and operating effectiveness of controls at a service organization (referred to in this SAE as a "type 2 report")* – A report that comprises:
 - (i) The service organization's description of its system;
 - (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:
 - a. The description fairly presents the service organization's system as designed and implemented throughout the specified period;
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
 - c. The controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period; and
 - (iii) A service auditor's assurance report that:
 - a. Conveys reasonable assurance about the matters in (ii)a.-c. above; and
 - b. Includes a description of the tests of controls and the results thereof.
- (l) *Service auditor* – A professional accountant in public practice who, at the request of the service

I.702 Auditing Pronouncements

organization, provides an assurance report on controls at a service organization.

- (m) *Service organization* – A third-party organization (or segment of a third-party organization) that provides services to user entities that are likely to be relevant to user entities' internal control as it relates to financial reporting.
- (n) *Service organization's system (or the system)* – The policies and procedures designed and implemented by the service organization to provide user entities with the services covered by the service auditor's assurance report. The service organization's description of its system includes identification of: the services covered; the period, or in the case of a type 1 report, the date, to which the description relates; control objectives; and related controls.
- (o) *Service organization's assertion* – The written assertion about the matters referred to in paragraph 9(k)(ii) (or paragraph 9(j)(ii) in the case of a type 1 report).
- (p) *Subservice organization* – A service organization used by another service organization to perform some of the services provided to user entities that are likely to be relevant to user entities' internal control as it relates to financial reporting.
- (q) *Test of controls* – A procedure designed to evaluate the operating effectiveness of controls in achieving the control objectives stated in the service organization's description of its system.
- (r) *User auditor* – An auditor who audits and reports on the financial statements of a user entity⁶.
- (s) *User entity* – An entity that uses a service organization.

Requirements

Framework for Assurance Engagements

10. The service auditor shall not represent compliance with this SAE unless the service auditor has complied with the requirements of this SAE and the requirements of the Framework for Assurance Engagements.

Ethical Requirements

11. The service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements. (Ref: Para. A5)

Management and Those Charged with Governance

12. Where this SAE requires the service auditor to inquire of, request representations from, communicate with, or otherwise interact with the service organization, the service auditor shall determine the appropriate person(s) within the service organization's management or governance structure with whom to interact. This shall include consideration of which person(s) have the appropriate responsibilities for and knowledge of the matters concerned. (Ref: Para. A6)

Acceptance and Continuance

13. Before agreeing to accept, or continue, an engagement the service auditor shall:

- (a) Determine whether:
 - (i) The service auditor has the capabilities and competence to perform the engagement; (Ref: Para. A7)
 - (ii) The criteria to be applied by the service organization to prepare the description of its system will

⁶ In the case of a subservice organization, the service auditor of a service organization that uses the services of the subservice organization is also a user auditor.

- be suitable and available to user entities and their auditors; and
- (iii) The scope of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.
- (b) Obtain the agreement of the service organization that it acknowledges and understands its responsibility:
- (i) For the preparation of the description of its system, and accompanying service organization's assertion, including the completeness, accuracy and method of presentation of that description and assertion; (Ref: Para. A8)
 - (ii) To have a reasonable basis for the service organization's assertion accompanying the description of its system; (Ref: Para. A9)
 - (iii) For stating in the service organization's assertion the criteria it used to prepare the description of its system;
 - (iv) For stating in the description of its system:
 - a. The control objectives; and,
 - b. Where they are specified by law or regulation, or another party (for example, a user group or a professional body), the party who specified them;
 - (v) For identifying the risks that threaten achievement of the control objectives stated in the description of its system, and designing and implementing controls to provide reasonable assurance that those risks will not prevent achievement of the control objectives stated in the description of its system, and therefore that the stated control objectives will be achieved; and (Ref: Para. A10)
 - (vi) To provide the service auditor with:
 - a. Access to all information, such as records, documentation and other matters, including service level agreements, of which the service organization is aware that is relevant to the description of the service organization's system and the accompanying service organization's assertion;
 - b. Additional information that the service auditor may request from the service organization for the purpose of the assurance engagement; and
 - c. Unrestricted access to persons within the service organization from whom the service auditor determines it necessary to obtain evidence.

Acceptance of a Change in the Terms of the Engagement

14. If the service organization requests a change in the scope of the engagement before the completion of the engagement, the service auditor shall be satisfied that there is a reasonable justification for the change. (Ref: Para. A11-A12)

Assessing the Suitability of the Criteria

15. As required by Framework for Assurance Engagements, the service auditor shall assess whether the service organization has used suitable criteria in preparing the description of its system, in evaluating whether controls are suitably designed, and, in the case of a type 2 report, in evaluating whether controls are operating effectively⁷.

⁷ Framework for Assurance Engagements, paragraphs 33-36.

I.704 Auditing Pronouncements

16. In assessing the suitability of the criteria to evaluate the service organization's description of its system, the service auditor shall determine if the criteria encompass, at a minimum:

- (a) Whether the description presents how the service organization's system was designed and implemented, including, as appropriate:
 - (i) The types of services provided, including, as appropriate, classes of transactions processed;
 - (ii) The procedures, within both information technology and manual systems, by which services are provided, including, as appropriate, procedures by which transactions are initiated, recorded, processed, corrected as necessary, and transferred to the reports and other information prepared for user entities;
 - (iii) The related records and supporting information, including, as appropriate, accounting records, supporting information and specific accounts that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports and other information prepared for user entities;
 - (iv) How the service organization's system deals with significant events and conditions, other than transactions;
 - (v) The process used to prepare reports and other information for user entities;
 - (vi) The specified control objectives and controls designed to achieve those objectives;
 - (vii) Complementary user entity controls contemplated in the design of the controls; and
 - (viii) Other aspects of the service organization's control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to the services provided.
- (b) In the case of a type 2 report, whether the description includes relevant details of changes to the service organization's system during the period covered by the description.
- (c) Whether the description omits or distorts information relevant to the scope of the service organization's system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities and their auditors and may not, therefore, include every aspect of the service organization's system that each individual user entity and its auditor may consider important in its particular environment.

17. In assessing the suitability of the criteria to evaluate the design of controls, the service auditor shall determine if the criteria encompass, at a minimum, whether:

- (a) The service organization has identified the risks that threaten achievement of the control objectives stated in the description of its system; and
- (b) The controls identified in that description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.

18. In assessing the suitability of the criteria to evaluate the operating effectiveness of controls in providing reasonable assurance that the stated control objectives identified in the description will be achieved, the service auditor shall determine if the criteria encompass, at a minimum, whether the controls were consistently applied as designed throughout the specified period. This includes whether manual controls were applied by individuals who have the appropriate competence and authority. (Ref: Para. A13-A15)

Materiality

19. When planning and performing the engagement, the service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a

type 2 report, the operating effectiveness of controls. (Ref: Para. A16-A18)

Obtaining an Understanding of the Service Organization's System

20. The service auditor shall obtain an understanding of the service organization's system, including controls that are included in the scope of the engagement. (Ref: Para. A19-A20)

Obtaining Evidence Regarding the Description

21. The service auditor shall obtain and read the service organization's description of its system, and shall evaluate whether those aspects of the description included in the scope of the engagement are fairly presented, including whether: (Ref: Para. A21-A22)

- (a) Control objectives stated in the service organization's description of its system are reasonable in the circumstances; (Ref: Para. A23)
- (b) Controls identified in that description were implemented;
- (c) Complementary user entity controls, if any, are adequately described; and
- (d) Services performed by a subservice organization, if any, are adequately described, including whether the inclusive method or the carve-out method has been used in relation to them.

22. The service auditor shall determine, through other procedures in combination with inquiries, whether the service organization's system has been implemented. Those other procedures shall include observation, and inspection of records and other documentation, of the manner in which the service organization's system operates and controls are applied. (Ref: Para. A24)

Obtaining Evidence Regarding Design of Controls

23. The service auditor shall determine which of the controls at the service organization are necessary to achieve the control objectives stated in the service organization's description of its system, and shall assess whether those controls were suitably designed. This determination shall include: (Ref: Para. A25-A27)

- (a) Identifying the risks that threaten the achievement of the control objectives stated in the service organization's description of its system; and
- (b) Evaluating the linkage of controls identified in the service organization's description of its system with those risks.

Obtaining Evidence Regarding Operating Effectiveness of Controls

24. When providing a type 2 report, the service auditor shall test those controls that the service auditor has determined are necessary to achieve the control objectives stated in the service organization's description of its system, and assess their operating effectiveness throughout the period. Evidence obtained in prior engagements about the satisfactory operation of controls in prior periods does not provide a basis for a reduction in testing, even if it is supplemented with evidence obtained during the current period. (Ref: Para. A28-A32)

25. When designing and performing tests of controls, the service auditor shall:

- (a) Perform other procedures in combination with inquiry to obtain evidence about:
 - (i) How the control was applied;
 - (ii) The consistency with which the control was applied; and
 - (iii) By whom or by what means the control was applied;
- (b) Determine whether controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain evidence supporting the operating effectiveness of those indirect controls; and (Ref: Para. A33-A34)

I.706 Auditing Pronouncements

(c) Determine means of selecting items for testing that are effective in meeting the objectives of the procedure. (Ref: Para. A35-A36)

26. When determining the extent of tests of controls, the service auditor shall consider matters including the characteristics of the population to be tested, which includes the nature of controls, the frequency of their application (for example, monthly, daily, a number of times per day), and the expected rate of deviation.

Sampling

27. When the service auditor uses sampling, the service auditor shall: (Ref: Para. A35-A36)

- (a) Consider the purpose of the procedure and the characteristics of the population from which the sample will be drawn when designing the sample;
- (b) Determine a sample size sufficient to reduce sampling risk to an appropriately low level;
- (c) Select items for the sample in such a way that each sampling unit in the population has a chance of selection;
- (d) If a designed procedure is not applicable to a selected item, perform the procedure on a replacement item; and
- (e) If unable to apply the designed procedures, or suitable alternative procedures, to a selected item, treat that item as a deviation.

Nature and Cause of Deviations

28. The service auditor shall investigate the nature and cause of any deviations identified and shall determine whether:

- (a) Identified deviations are within the expected rate of deviation and are acceptable; therefore, the testing that has been performed provides an appropriate basis for concluding that the control is operating effectively throughout the specified period;
- (b) Additional testing of the control or of other controls is necessary to reach a conclusion on whether the controls relative to a particular control objective are operating effectively throughout the specified period; or (Ref: Para. A25)
- (c) The testing that has been performed provides an appropriate basis for concluding that the control did not operate effectively throughout the specified period.

29. In the extremely rare circumstances when the service auditor considers a deviation discovered in a sample to be an anomaly and no other controls have been identified that allow the service auditor to conclude that the relevant control objective is operating effectively throughout the specified period, the service auditor shall obtain a high degree of certainty that such deviation is not representative of the population. The service auditor shall obtain this degree of certainty by performing additional procedures to obtain sufficient appropriate evidence that the deviation does not affect the remainder of the population.

The Work of an Internal Audit Function⁸

Obtaining an Understanding of the Internal Audit Function

30. If the service organization has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the internal audit function is likely to be relevant to the engagement. (Ref: Para. A37)

⁸ This SAE does not deal with instances when individual internal auditors provide direct assistance to the service auditor in carrying out audit procedures.

Determining Whether and to What Extent to Use the Work of the Internal Auditors

31. The service auditor shall determine:
- (a) Whether the work of the internal auditors is likely to be adequate for purposes of the engagement; and
 - (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures.
32. In determining whether the work of the internal auditors is likely to be adequate for purposes of the engagement, the service auditor shall evaluate:
- (a) The objectivity of the internal audit function;
 - (b) The technical competence of the internal auditors;
 - (c) Whether the work of the internal auditors is likely to be carried out with due professional care; and
 - (d) Whether there is likely to be effective communication between the internal auditors and the service auditor.
33. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures, the service auditor shall consider: (Ref: Para. A38)
- (a) The nature and scope of specific work performed, or to be performed, by the internal auditors;
 - (b) The significance of that work to the service auditor's conclusions; and
 - (c) The degree of subjectivity involved in the evaluation of the evidence gathered in support of those conclusions.

Using the Work of the Internal Audit Function

34. In order for the service auditor to use specific work of the internal auditors, the service auditor shall evaluate and perform procedures on that work to determine its adequacy for the service auditor's purposes. (Ref: Para. A39)
35. To determine the adequacy of specific work performed by the internal auditors for the service auditor's purposes, the service auditor shall evaluate whether:
- (a) The work was performed by internal auditors having adequate technical training and proficiency;
 - (b) The work was properly supervised, reviewed and documented;
 - (c) Adequate evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
 - (d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
 - (e) Exceptions relevant to the engagement or unusual matters disclosed by the internal auditors are properly resolved.

Effect on the Service Auditor's Assurance Report

36. If the work of the internal audit function has been used, the service auditor shall make no reference to that work in the section of the service auditor's assurance report that contains the service auditor's opinion. (Ref: Para. A40)
37. In the case of a type 2 report, if the work of the internal audit function has been used in performing tests of controls, that part of the service auditor's assurance report that describes the service auditor's tests of controls and the results thereof shall include a description of the internal auditor's work and of the service auditor's procedures with respect to that work. (Ref: Para. A41)

I.708 Auditing Pronouncements

Written Representations

38. The service auditor shall request the service organization to provide written representations: (Ref: Para. A42)

- (a) That reaffirm the assertion accompanying the description of the system;
- (b) That it has provided the service auditor with all relevant information and access agreed to;⁹ and
- (c) That it has disclosed to the service auditor any of the following of which it is aware:
 - (i) Non-compliance with laws and regulations, fraud, or uncorrected deviations attributable to the service organization that may affect one or more user entities;
 - (ii) Design deficiencies in controls;
 - (iii) Instances where controls have not operated as described; and
 - (iv) Any events subsequent to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.

39. The written representations shall be in the form of a representation letter addressed to the service auditor. The date of the written representations shall be as near as practicable to, but not after, the date of the service auditor's assurance report.

40. If, having discussed the matter with the service auditor, the service organization does not provide one or more of the written representations requested in accordance with paragraph 38(a) and (b) of this SAE, the service auditor shall disclaim an opinion. (Ref: Para. A43)

Other Information

41. The service auditor shall read the other information, if any, included in a document containing the service organization's description of its system and the service auditor's assurance report, to identify material inconsistencies, if any, with that description. While reading the other information for the purpose of identifying material inconsistencies, the service auditor may become aware of an apparent misstatement of fact in that other information.

42. If the service auditor becomes aware of a material inconsistency or an apparent misstatement of fact in the other information, the service auditor shall discuss the matter with the service organization. If the service auditor concludes that there is a material inconsistency or a misstatement of fact in the other information that the service organization refuses to correct, the service auditor shall take further appropriate action. (Ref: Para. A44-A45)

Subsequent Events

43. The service auditor shall inquire whether the service organization is aware of any events subsequent to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report. If the service auditor is aware of such an event, and information about that event is not disclosed by the service organization, the service auditor shall disclose it in the service auditor's assurance report.

44. The service auditor has no obligation to perform any procedures regarding the description of the service organization's system, or the suitability of design or operating effectiveness of controls, after the date of the service auditor's assurance report.

⁹ Paragraph 13(b)(vi) of this SAE.

Documentation

45. The service auditor shall prepare documentation that is sufficient to enable an experienced service auditor, having no previous connection with the engagement, to understand:

- (a) The nature, timing, and extent of the procedures performed to comply with this SAE and applicable legal and regulatory requirements;
- (b) The results of the procedures performed, and the evidence obtained; and
- (c) Significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions.

46. In documenting the nature, timing and extent of procedures performed, the service auditor shall record:

- (a) The identifying characteristics of the specific items or matters being tested;
- (b) Who performed the work and the date such work was completed; and
- (c) Who reviewed the work performed and the date and extent of such review.

47. If the service auditor uses specific work of the internal auditors, the service auditor shall document the conclusions reached regarding the evaluation of the adequacy of the work of the internal auditors, and the procedures performed by the service auditor on that work.

48. The service auditor shall document discussions of significant matters with the service organization and others including the nature of the significant matters discussed and when and with whom the discussions took place.

49. If the service auditor has identified information that is inconsistent with the service auditor's final conclusion regarding a significant matter, the service auditor shall document how the service auditor addressed the inconsistency.

50. The service auditor shall assemble the documentation in an engagement file and complete the administrative process of assembling the final engagement file on a timely basis after the date of the service auditor's assurance report¹⁰.

51. After the assembly of the final engagement file has been completed, the service auditor shall not delete or discard documentation before the end of its retention period. (Ref: Para. A46)

52. If the service auditor finds it necessary to modify existing engagement documentation or add new documentation after the assembly of the final engagement file has been completed and that documentation does not affect the service auditor's report, the service auditor shall, regardless of the nature of the modifications or additions, document:

- (a) The specific reasons for making them; and
- (b) When and by whom they were made and reviewed.

Preparing the Service Auditor's Assurance Report

Content of the Service Auditor's Assurance Report

53. The service auditor's assurance report shall include the following basic elements: (Ref: Para. A47)

- (a) A title that clearly indicates the report is an independent service auditor's assurance report.
- (b) An addressee.
- (c) Identification of:

¹⁰ Standard on Quality Control (SQC) 1, paragraphs 74-76, provide further guidance.

I.710 Auditing Pronouncements

- (i) The service organization's description of its system, and the service organization's assertion, which includes the matters described in paragraph 9(k)(ii) for a type 2 report, or paragraph 9(j)(ii) for a type 1 report.
 - (ii) Those parts of the service organization's description of its system, if any, that are not covered by the service auditor's opinion.
 - (iii) If the description refers to the need for complementary user entity controls, a statement that the service auditor has not evaluated the suitability of design or operating effectiveness of complementary user entity controls, and that the control objectives stated in the service organization's description of its system can be achieved only if complementary user entity controls are suitably designed or operating effectively, along with the controls at the service organization.
 - (iv) If services are performed by a subservice organization, the nature of activities performed by the subservice organization as described in the service organization's description of its system and whether the inclusive method or the carve-out method has been used in relation to them. Where the carve-out method has been used, a statement that the service organization's description of its system excludes the control objectives and related controls at relevant subservice organizations, and that the service auditor's procedures do not extend to controls at the subservice organization. Where the inclusive method has been used, a statement that the service organization's description of its system includes control objectives and related controls at the subservice organization, and that the service auditor's procedures extended to controls at the subservice organization.
- (d) Identification of the criteria, and the party specifying the control objectives.
- (e) A statement that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. (Ref: Para. A48)
- (f) A statement that the service organization is responsible for:
- (i) Preparing the description of its system, and the accompanying assertion, including the completeness, accuracy and method of presentation of that description and that assertion;
 - (ii) Providing the services covered by the service organization's description of its system;
 - (iii) Stating the control objectives (where not identified by law or regulation, or another party, for example, a user group or a professional body); and
 - (iv) Designing and implementing controls to achieve the control objectives stated in the service organization's description of its system.
- (g) A statement that the service auditor's responsibility is to express an opinion on the service organization's description, on the design of controls related to the control objectives stated in that description and, in the case of a type 2 report, on the operating effectiveness of those controls, based on the service auditor's procedures.
- (h) A statement that the engagement was performed in accordance with SAE 3402, "Assurance Reports on Controls at a Service Organization," which requires that the service auditor comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether, in all material respects, the service organization's description of its system is fairly presented and the controls are suitably designed and, in the case of a type 2 report, are operating effectively.

- (i) A summary of the service auditor's procedures to obtain reasonable assurance and a statement of the service auditor's belief that the evidence obtained is sufficient and appropriate to provide a basis for the service auditor's opinion, and, in the case of a type 1 report, a statement that the service auditor has not performed any procedures regarding the operating effectiveness of controls and therefore no opinion is expressed thereon.
 - (j) A statement of the limitations of controls and, in the case of a type 2 report, of the risk of projecting to future periods any evaluation of the operating effectiveness of controls.
 - (k) The service auditor's opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:
 - (i) In the case of a type 2 report:
 - a. The description fairly presents the service organization's system that had been designed and implemented throughout the specified period;
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
 - c. The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.
 - (ii) In the case of a type 1 report:
 - a. The description fairly presents the service organization's system that had been designed and implemented as at the specified date; and
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date.
 - (l) The date of the service auditor's assurance report, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.
 - (m) **Practitioner's Signature**—The report should be signed by the practitioner in his personal name. Where the firm is appointed, the report should be signed in the personal name of the engagement partner and in the name of the firm. The partner/proprietor signing the assurance report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India (the Institute). If Partnership/proprietorship firm is appointed, the registration number of the firm, as may be allotted by the Institute, also needs to be mentioned in the assurance reports signed by them.
 - (n) **The place of signature** – the report should name specific location, which is ordinarily the city where the report is signed.
54. In the case of a type 2 report, the service auditor's assurance report shall include a separate section after the opinion, or an attachment, that describes the tests of controls that were performed and the results of those tests. In describing the tests of controls, the service auditor shall clearly state which controls were tested, identify whether the items tested represent all or a selection of the items in the population, and indicate the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments. If deviations have been identified, the service auditor shall include the extent of testing performed that led to identification of the deviations (including the sample size where sampling has been used), and the number and nature of the deviations noted. The service auditor shall report deviations even if, on the basis of tests performed, the service auditor has concluded that the related control objective was achieved. (Ref: Para. A18 and A49)

I.712 Auditing Pronouncements

Modified Opinions

55. If the service auditor concludes that: (Ref: Para. A50-A52)
- (a) The service organization's description does not fairly present, in all material respects, the system as designed and implemented;
 - (b) The controls related to the control objectives stated in the description were not suitably designed, in all material respects;
 - (c) In the case of a type 2 report, the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved, did not operate effectively, in all material respects; or
 - (d) The service auditor is unable to obtain sufficient appropriate evidence, the service auditor's opinion shall be modified, and the service auditor's assurance report shall contain a clear description of all the reasons for the modification.

Other Communication Responsibilities

56. If the service auditor becomes aware of non-compliance with laws and regulations, fraud, or uncorrected errors attributable to the service organization that are not clearly trivial and may affect one or more user entities, the service auditor shall determine whether the matter has been communicated appropriately to affected user entities. If the matter has not been so communicated and the service organization is unwilling to do so, the service auditor shall take appropriate action. (Ref: Para. A53)

Application and Other Explanatory Material

Scope of this SAE (Ref: Para. 1 and 3)

A1. Internal control is a process designed to provide reasonable assurance regarding the achievement of objectives related to the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Controls related to a service organization's operations and compliance objectives may be relevant to a user entity's internal control as it relates to financial reporting. Such controls may pertain to assertions about presentation and disclosure relating to account balances, classes of transactions or disclosures, or may pertain to evidence that the user auditor evaluates or uses in applying auditing procedures. For example, a payroll processing service organization's controls related to the timely remittance of payroll deductions to government authorities may be relevant to a user entity as late remittances could incur interest and penalties that would result in a liability for the user entity. Similarly, a service organization's controls over the acceptability of investment transactions from a regulatory perspective may be considered relevant to a user entity's presentation and disclosure of transactions and account balances in its financial statements. The determination of whether controls at a service organization related to operations and compliance are likely to be relevant to user entities' internal control as it relates to financial reporting is a matter of professional judgment, having regard to the control objectives set by the service organization and the suitability of the criteria.

A2. The service organization may not be able to assert that the system is suitably designed when, for example, the service organization is operating a system that has been designed by a user entity or is stipulated in a contract between a user entity and the service organization. Because of the inextricable link between the suitable design of controls and their operating effectiveness, the absence of an assertion with respect to the suitability of design will likely preclude the service auditor from concluding that the controls provide reasonable assurance that the control objectives have been met and thus from opining on the operating effectiveness of controls. As an alternative, the practitioner may choose to accept an agreed-upon procedures engagement to perform tests of controls, or an assurance engagement to conclude on whether, based on tests of controls, the controls have operated as described.

Definitions (Ref: Para. 9(d) and 9(g))

A3. The definition of “controls at the service organization” includes aspects of user entities’ information systems maintained by the service organization, and may also include aspects of one or more of the other components of internal control at a service organization. For example, it may include aspects of a service organization’s control environment, monitoring, and control activities when they relate to the services provided. It does not, however, include controls at a service organization that are not related to the achievement of the control objectives stated in the service organization’s description of its system, for example, controls related to the preparation of the service organization’s own financial statements.

A4. When the inclusive method is used, the requirements in this SAE also apply to the services provided by the subservice organization, including obtaining agreement regarding the matters in paragraph 13(b)(i)-(v) as applied to the subservice organization rather than the service organization. Performing procedures at the subservice organization entails coordination and communication between the service organization, the subservice organization, and the service auditor. The inclusive method generally is feasible only if the service organization and the subservice organization are related, or if the contract between the service organization and the subservice organization provides for its use.

Ethical Requirements (Ref: Para. 11)

A5. The service auditor is subject to relevant independence requirements, which ordinarily comprise *Code of Ethics* of the Institute. In performing an engagement in accordance with this SAE, the *Code of Ethics* of the ICAI does not require the service auditor to be independent from each user entity.

Management and Those Charged with Governance (Ref: Para. 12)

A6. Management and governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. Such diversity means that it is not possible for this SAE to specify for all engagements the person(s) with whom the service auditor is to interact regarding particular matters. For example, the service organization may be a segment of a third-party organization and not a separate legal entity. In such cases, identifying the appropriate management personnel or those charged with governance from whom to request written representations may require the exercise of professional judgment.

Acceptance and Continuance

Capabilities and Competence to Perform the Engagement (Ref: Para. 13(a)(i))

A7. Relevant capabilities and competence to perform the engagement include matters such as the following:

- Knowledge of the relevant industry;
- An understanding of information technology and systems;
- Experience in evaluating risks as they relate to the suitable design of controls; and
- Experience in the design and execution of tests of controls and the evaluation of the results.

Service Organization’s Assertion (Ref: Para. 13(b)(i))

A8. Refusal, by a service organization, to provide a written assertion, subsequent to an agreement by the service auditor to accept, or continue, an engagement, represents a scope limitation that causes the service auditor to withdraw from the engagement. If law or regulation does not allow the service auditor to withdraw from the engagement, the service auditor disclaims an opinion.

Reasonable Basis for Service Organization’s Assertion (Ref: Para. 13(b)(ii))

A9. In the case of a type 2 report, the service organization’s assertion includes a statement that the

I.714 Auditing Pronouncements

controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period. This assertion may be based on the service organization's monitoring activities. Monitoring of controls is a process to assess the effectiveness of controls over time. It involves assessing the effectiveness of controls on a timely basis, identifying and reporting deficiencies to appropriate individuals within the service organization, and taking necessary corrective actions. The service organization accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of both. The greater the degree and effectiveness of ongoing monitoring activities, the less need for separate evaluations. Ongoing monitoring activities are often built into the normal recurring activities of a service organization and include regular management and supervisory activities. Internal auditors or personnel performing similar functions may contribute to the monitoring of a service organization's activities. Monitoring activities may also include using information communicated by external parties, such as customer complaints and regulator comments, which may indicate problems or highlight areas in need of improvement. The fact that the service auditor will report on the operating effectiveness of controls is not a substitute for the service organization's own processes to provide a reasonable basis for its assertion.

Identification of Risks (Ref: Para. 13(b)(iv))

A10. As noted in paragraph 9(c), control objectives relate to risks that controls seek to mitigate. For example, the risk that a transaction is recorded at the wrong amount or in the wrong period can be expressed as a control objective that transactions are recorded at the correct amount and in the correct period. The service organization is responsible for identifying the risks that threaten achievement of the control objectives stated in the description of its system. The service organization may have a formal or informal process for identifying relevant risks. A formal process may include estimating the significance of identified risks, assessing the likelihood of their occurrence, and deciding about actions to address them. However, since control objectives relate to risks that controls seek to mitigate, thoughtful identification of control objectives when designing and implementing the service organization's system may itself comprise an informal process for identifying relevant risks.

Acceptance of a Change in the Terms of the Engagement (Ref: Para. 14)

A11. A request to change the scope of the engagement may not have a reasonable justification when, for example, the request is made to exclude certain control objectives from the scope of the engagement because of the likelihood that the service auditor's opinion would be modified; or the service organization will not provide the service auditor with a written assertion and the request is made to perform the engagement under Framework for Assurance Engagements.

A12. A request to change the scope of the engagement may have a reasonable justification when, for example, the request is made to exclude from the engagement a subservice organization when the service organization cannot arrange for access by the service auditor, and the method used for dealing with the services provided by that subservice organization is changed from the inclusive method to the carve-out method.

Assessing the Suitability of the Criteria (Ref: Para. 15-18)

A13. Criteria need to be available to the intended users to allow them to understand the basis for the service organization's assertion about the fair presentation of its description of the system, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of the controls related to the control objectives.

A14. Framework for Assurance Engagements requires the service auditor, among other things, to assess

the suitability of criteria, and the appropriateness of the subject matter¹¹. The subject matter is the underlying condition of interest to intended users of an assurance report. The following table identifies the subject matter and minimum criteria for each of the opinions in type 2 and type 1 reports.

	Subject matter	Criteria	Comment	
Opinion about the fair presentation of the service organization's system (type 1 and type 2 reports)	The service organization's system that is likely to be relevant to user entities' internal control as it relates to financial reporting and is covered by the service auditor's assurance report.	The description is fairly presented if it: (a) presents how the service organization's system was designed and implemented including, as appropriate, the matters identified in paragraph 16(a)(i)-(viii); (b) in the case of a type 2 report, includes relevant details of changes to the service organization's system during the period covered by the description; and (c) does not omit or distort information relevant to the scope of the service organization's system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities and may not, therefore, include every aspect of the service organization's system that each individual user entity may consider important in its own particular environment.	The specific wording of the criteria for this opinion may need to be tailored to be consistent with criteria established by, for example, law or regulation, user groups, or a professional body. Examples of criteria for this opinion are provided in the illustrative service organization's assertion in Appendix 1. Paragraphs A21-A24 offer further guidance on determining whether these criteria are met. (The subject matter information ¹² for this opinion is the service organization's description of its system and the service organization's assertion that the description is fairly presented.)	
Opinion about suitability of design, and operating effectiveness	The suitability of the design and operating effectiveness of those controls that are necessary to achieve the control	The controls are suitably designed and operating effectively if: (a) the service organization has identified the risks that threaten achievement of the control objectives	When the criteria for this opinion are met, controls will have provided reasonable assurance that	The control objectives, which are stated in the service organization's description of

¹¹ Framework for Assurance Engagements, paragraph 16(b). Members attention is also drawn to ISAE 3000, paragraphs 18-19.

¹² The "subject matter information" is the outcome of the evaluation or measurement of the subject matter.

I.716 Auditing Pronouncements

<p>s (type 2 reports)</p>	<p>objectives stated in the service organization's description of its system.</p>	<p>stated in the description of its system; (b) the controls identified in that description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved; and (c) the controls were consistently applied as designed throughout the specified period. This includes whether manual controls were applied by individuals who have the appropriate competence and authority.</p>	<p>the related control objectives were achieved throughout the specified period. (The subject matter information for this opinion is the service organization's assertion that controls are suitably designed and that they are operating effectively.)</p>	<p>its system, are part of the criteria for these opinions. The stated control objectives will differ from engagement to engagement. If, as part of forming the opinion on the description, the service auditor concludes the stated control objectives are not fairly presented then those control objectives would not be suitable as part of the criteria for forming an opinion on either the design or operating effectiveness of controls.</p>
<p>Opinion about suitability of design (type 1 reports)</p>	<p>The suitability of the design of those controls that are necessary to achieve the control objectives stated in the service organization's description of its system.</p>	<p>The controls are suitably designed if: (a) the service organization has identified the risks that threaten achievement of the control objectives stated in the description of its system; and (b) the controls identified in that description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.</p>	<p>Meeting these criteria does not, of itself, provide any assurance that the related control objectives were achieved because no assurance has been obtained about the operation of controls. (The subject matter information for this opinion is the service organization's assertion that controls are suitably designed.)</p>	<p>Meeting these criteria does not, of itself, provide any assurance that the related control objectives were achieved because no assurance has been obtained about the operation of controls. (The subject matter information for this opinion is the service organization's assertion that controls are suitably designed.)</p>

A15. Paragraph 16(a) identifies a number of elements that are included in the service organization's description of its system as appropriate. These elements may not be appropriate if the system being described is not a system that processes transactions, for example, if the system relates to general controls over the hosting of an IT application but not the controls embedded in the application itself.

Materiality (Ref: Para. 19 and 54)

A16. In an engagement to report on controls at a service organization, the concept of materiality relates to the system being reported on, not the financial statements of user entities. The service auditor plans and performs procedures to determine whether the service organization's description of its system is fairly presented in all material respects, whether controls at the service organization are suitably designed in all material respects and, in the case of a type 2 report, whether controls at the service organization are operating effectively in all material respects. The concept of materiality takes into account that the service auditor's assurance report provides information about the service organization's system to meet the common information needs of a broad range of user entities and their auditors who have an understanding of the manner in which that system has been used.

A17. Materiality with respect to the fair presentation of the service organization's description of its system, and with respect to the design of controls, includes primarily the consideration of qualitative factors, for example: whether the description includes the significant aspects of processing significant transactions; whether the description omits or distorts relevant information; and the ability of controls, as designed, to provide reasonable assurance that control objectives would be achieved. Materiality with respect to the service auditor's opinion on the operating effectiveness of controls includes the consideration of both quantitative and qualitative factors, for example, the tolerable rate and observed rate of deviation (a quantitative matter), and the nature and cause of any observed deviation (a qualitative matter).

A18. The concept of materiality is not applied when disclosing, in the description of the tests of controls, the results of those tests where deviations have been identified. This is because, in the particular circumstances of a specific user entity or user auditor, a deviation may have significance beyond whether or not, in the opinion of the service auditor, it prevents a control from operating effectively. For example, the control to which the deviation relates may be particularly significant in preventing a certain type of error that may be material in the particular circumstances of a user entity's financial statements.

Obtaining an Understanding of the Service Organization's System (Ref: Para. 20)

A19. Obtaining an understanding of the service organization's system, including controls, included in the scope of the engagement, assists the service auditor in:

- Identifying the boundaries of that system, and how it interfaces with other systems.
- Assessing whether the service organization's description fairly presents the system that has been designed and implemented.
- Determining which controls are necessary to achieve the control objectives stated in the service organization's description of its system.
- Assessing whether controls were suitably designed.
- Assessing, in the case of a type 2 report, whether controls were operating effectively.

A20. The service auditor's procedures to obtain this understanding may include:

- Inquiring of those within the service organization who, in the service auditor's judgment, may have relevant information.
- Observing operations and inspecting documents, reports, printed and electronic records of transaction processing.
- Inspecting a selection of agreements between the service organization and user entities to identify their common terms.

I.718 Auditing Pronouncements

- Reperforming control procedures.

Obtaining Evidence Regarding the Description (Ref: Para. 21-22)

A21. Considering the following questions may assist the service auditor in determining whether those aspects of the description included in the scope of the engagement are fairly presented in all material respects:

- Does the description address the major aspects of the service provided (within the scope of the engagement) that could reasonably be expected to be relevant to the common needs of a broad range of user auditors in planning their audits of user entities' financial statements?
- Is the description prepared at a level of detail that could reasonably be expected to provide a broad range of user auditors with sufficient information to obtain an understanding of internal control in accordance with SA 31513? The description need not address every aspect of the service organization's processing or the services provided to user entities, and need not be so detailed as to potentially allow a reader to compromise security or other controls at the service organization.
- Is the description prepared in a manner that does not omit or distort information that may affect the common needs of a broad range of user auditors' decisions, for example, does the description contain any significant omissions or inaccuracies in processing of which the service auditor is aware?
- Where some of the control objectives stated in the service organization's description of its system have been excluded from the scope of the engagement, does the description clearly identify the excluded objectives?
- Have the controls identified in the description been implemented?
- Are complementary user entity controls, if any, described adequately? In most cases, the description of control objectives is worded such that the control objectives are capable of being achieved through effective operation of controls implemented by the service organization alone. In some cases, however, the control objectives stated in the service organization's description of its system cannot be achieved by the service organization alone because their achievement requires particular controls to be implemented by user entities. This may be the case where, for example, the control objectives are specified by a regulatory authority. When the description does include complementary user entity controls, the description separately identifies those controls along with the specific control objectives that cannot be achieved by the service organization alone.
- If the inclusive method has been used, does the description separately identify controls at the service organization and controls at the subservice organization? If the carve-out method is used, does the description identify the functions that are performed by the subservice organization? When the carve-out method is used, the description need not describe the detailed processing or controls at the subservice organization.

A22. The service auditor's procedures to evaluate the fair presentation of the description may include:

- Considering the nature of user entities and how the services provided by the service organization are likely to affect them, for example, whether user entities are from a particular industry and whether they are regulated by government agencies.
- Reading standard contracts, or standard terms of contracts, (if applicable) with user entities to gain an understanding of the service organization's contractual obligations.

¹³ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

- Observing procedures performed by service organization personnel.
- Reviewing the service organization's policy and procedure manuals and other systems documentation, for example, flowcharts and narratives.

A23. Paragraph 21(a) requires the service auditor to evaluate whether the control objectives stated in the service organization's description of its system are reasonable in the circumstances.

Considering the following questions may assist the service auditor in this evaluation:

- Have the stated control objectives been designated by the service organization or by outside parties such as a regulatory authority, a user group, or a professional body that follows a transparent due process?
- Where the stated control objectives have been specified by the service organization, do they relate to the types of assertions commonly embodied in the broad range of user entities' financial statements to which controls at the service organization could reasonably be expected to relate? Although the service auditor ordinarily will not be able to determine how controls at a service organization specifically relate to the assertions embodied in individual user entities' financial statements, the service auditor's understanding of the nature of the service organization's system, including controls, and services being provided is used to identify the types of assertions to which those controls are likely to relate.
- Where the stated control objectives have been specified by the service organization, are they complete? A complete set of control objectives can provide a broad range of user auditors with a framework to assess the effect of controls at the service organization on the assertions commonly embodied in user entities' financial statements.

A24. The service auditor's procedures to determine whether the service organization's system has been implemented may be similar to, and performed in conjunction with, procedures to obtain an understanding of that system. They may also include tracing items through the service organization's system and, in the case of a type 2 report, specific inquiries about changes in controls that were implemented during the period. Changes that are significant to user entities or their auditors are included in the description of the service organization's system.

Obtaining Evidence Regarding Design of Controls (Ref: Para. 23 and 28(b))

A25. From the viewpoint of a user entity or a user auditor, a control is suitably designed if, individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that material misstatements are prevented, or detected and corrected. A service organization or a service auditor, however, is not aware of the circumstances at individual user entities that would determine whether or not a misstatement resulting from a control deviation is material to those user entities. Therefore, from the viewpoint of a service auditor, a control is suitably designed if, individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that control objectives stated in the service organization's description of its system are achieved.

A26. A service auditor may consider using flowcharts, questionnaires, or decision tables to facilitate understanding the design of the controls.

A27. Controls may consist of a number of activities directed at the achievement of a control objective. Consequently, if the service auditor evaluates certain activities as being ineffective in achieving a particular control objective, the existence of other activities may allow the service auditor to conclude that controls related to the control objective are suitably designed.

Obtaining Evidence Regarding Operating Effectiveness of Controls

Assessing Operating Effectiveness (Ref: Para. 24)

A28. From the viewpoint of a user entity or a user auditor, a control is operating effectively if, individually or in combination with other controls, it provides reasonable assurance that material misstatements, whether due to fraud or error, are prevented, or detected and corrected. A service organization or a service auditor, however, is not aware of the circumstances at individual user entities that would determine whether a misstatement resulting from a control deviation had occurred and, if so, whether it is material. Therefore, from the viewpoint of a service auditor, a control is operating effectively if, individually or in combination with other controls, it provides reasonable assurance that control objectives stated in the service organization's description of its system are achieved. Similarly, a service organization or a service auditor is not in a position to determine whether any observed control deviation would result in a material misstatement from the viewpoint of an individual user entity.

A29. Obtaining an understanding of controls sufficient to opine on the suitability of their design is not sufficient evidence regarding their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls as they were designed and implemented. For example, obtaining information about the implementation of a manual control at a point in time does not provide evidence about operation of the control at other times. However, because of the inherent consistency of IT processing, performing procedures to determine the design of an automated control, and whether it has been implemented, may serve as evidence of that control's operating effectiveness, depending on the service auditor's assessment and testing of other controls, such as those over program changes.

A30. To be useful to user auditors, a type 2 report ordinarily covers a minimum period of six months. If the period is less than six months, the service auditor may consider it appropriate to describe the reasons for the shorter period in the service auditor's assurance report. Circumstances that may result in a report covering a period of less than six months include when (a) the service auditor is engaged close to the date by which the report on controls is to be issued; (b) the service organization (or a particular system or application) has been in operation for less than six months; or (c) significant changes have been made to the controls and it is not practicable either to wait six months before issuing a report or to issue a report covering the system both before and after the changes.

A31. Certain control procedures may not leave evidence of their operation that can be tested at a later date and, accordingly, the service auditor may find it necessary to test the operating effectiveness of such control procedures at various times throughout the reporting period.

A32. The service auditor provides an opinion on the operating effectiveness of controls throughout each period, therefore, sufficient appropriate evidence about the operation of controls during the current period is required for the service auditor to express that opinion. Knowledge of deviations observed in prior engagements may, however, lead the service auditor to increase the extent of testing during the current period.

Testing of Indirect Controls (Ref: Para. 25(b))

A33. In some circumstances, it may be necessary to obtain evidence supporting the effective operation of indirect controls. For example, when the service auditor decides to test the effectiveness of a review of exception reports detailing sales in excess of authorized credit limits, the review and related follow up is the control that is directly of relevance to the service auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as "indirect" controls.

A34. Because of the inherent consistency of IT processing, evidence about the implementation of an automated application control, when considered in combination with evidence about the operating effectiveness of the service organization's general controls (in particular, change controls), may also provide

substantial evidence about its operating effectiveness.

Means of Selecting Items for Testing (Ref: Para. 25(c) and 27)

A35. The means of selecting items for testing available to the service auditor are:

- (a) Selecting all items (100% examination). This may be appropriate for testing controls that are applied infrequently, for example, quarterly, or when evidence regarding application of the control makes 100% examination efficient;
- (b) Selecting specific items. This may be appropriate where 100% examination would not be efficient and sampling would not be effective, such as testing controls that are not applied sufficiently frequently to render a large population for sampling, for example, controls that are applied monthly or weekly; and
- (c) Sampling. This may be appropriate for testing controls that are applied frequently in a uniform manner and which leave documentary evidence of their application.

A36. While selective examination of specific items will often be an efficient means of obtaining evidence, it does not constitute sampling. The results of procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide evidence concerning the remainder of the population. Sampling, on the other hand, is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

The Work of an Internal Audit Function

Obtaining an Understanding of the Internal Audit Function (Ref: Para. 30)

A37. An internal audit function may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to management and those charged with governance. An internal audit function at a service organization may perform activities related to the service organization's own system of internal control, or activities related to the services and systems, including controls, that the service organization is providing to user entities.

Determining Whether and to What Extent to Use the Work of the Internal Auditors (Ref: Para. 33)

A38. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures, the following factors may suggest the need for different or less extensive procedures than would otherwise be the case:

- The nature and scope of specific work performed, or to be performed, by the internal auditors is quite limited.
- The work of the internal auditors relates to controls that are less significant to the service auditor's conclusions.
- The work performed, or to be performed, by the internal auditors does not require subjective or complex judgments.

Using the Work of the Internal Audit Function (Ref: Para. 34)

A39. The nature, timing and extent of the service auditor's procedures on specific work of the internal auditors will depend on the service auditor's assessment of the significance of that work to the service auditor's conclusions (for example, the significance of the risks that the controls tested seek to mitigate), the evaluation of the internal audit function and the evaluation of the specific work of the internal auditors. Such procedures may include:

- Examination of items already examined by the internal auditors;
- Examination of other similar items; and

I.722 Auditing Pronouncements

- Observation of procedures performed by the internal auditors.

Effect on the Service Auditor's Assurance Report (Ref: Para. 36-37)

A40. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the service organization as is required of the service auditor when performing the engagement. The service auditor has sole responsibility for the opinion expressed in the service auditor's assurance report, and that responsibility is not reduced by the service auditor's use of the work of the internal auditors.

A41. The service auditor's description of work performed by the internal audit function may be presented in a number of ways, for example:

- By including introductory material to the description of tests of controls indicating that certain work of the internal audit function was used in performing tests of controls.
- Attribution of individual tests to internal audit.

Written Representations (Ref: Para. 38 and 40)

A42. The written representations required by paragraph 38 are separate from, and in addition to, the service organization's assertion, as defined at paragraph 9(o).

A43. If the service organization does not provide the written representations requested in accordance with paragraph 38(c) of this SAE, it may be appropriate for the service auditor's opinion to be modified in accordance with paragraph 55(d) of this SAE.

Other Information (Ref: Para. 42)

A44. The *Code of Ethics* of the ICAI requires that a service auditor not be associated with information where the service auditor believes that the information:

- (a) Contains a materially false or misleading statement;
- (b) Contains statements or information furnished negligently; or
- (c) Omits or obscures information required to be included where such omission or obscurity would be misleading¹⁴.

If other information included in a document containing the service organization's description of its system and the service auditor's assurance report contains future-oriented information such as recovery or contingency plans, or plans for modifications to the system that will address deviations identified in the service auditor's assurance report, or claims of a promotional nature that cannot be reasonably substantiated, the service auditor may request that information be removed or restated.

A45. If the service organization refuses to remove or restate the other information, further actions that may be appropriate include, for example:

- Requesting the service organization to consult with its legal counsel as to the appropriate course of action.
- Describing the material inconsistency or material misstatement of fact in the assurance report.
- Withholding the assurance report until the matter is resolved.
- Withdrawing from the engagement.

¹⁴ The Code of Ethics of the ICAI, paragraph 110.2.

Documentation (Ref: Para. 51)

A46. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of engagement files¹⁵. An appropriate time limit within which to complete the assembly of the final engagement file is ordinarily not more than 60 days after the date of the service auditor's report¹⁶.

Preparing the Service Auditor's Assurance Report

Content of the Service Auditor's Assurance Report (Ref: Para. 53)

A47. Illustrative examples of service auditors' assurance reports and related service organizations' assertions are contained in **Appendices 1 and 2**.

Intended Users and Purposes of the Service Auditor's Assurance Report (Ref: Para. 53(e))

A48. The criteria used for engagements to report on controls at a service organization are relevant only for the purposes of providing information about the service organization's system, including controls, to those who have an understanding of how the system has been used for financial reporting by user entities. Accordingly this is stated in the service auditor's assurance report. In addition, the service auditor may consider it appropriate to include wording that specifically restricts distribution of the assurance report other than to intended users, its use by others, or its use for other purposes.

Description of the Tests of Controls (Ref: Para. 54)

A49. In describing the nature of the tests of controls for a type 2 report, it assists readers of the service auditor's assurance report if the service auditor includes:

- The results of all tests where deviations have been identified, even if other controls have been identified that allow the service auditor to conclude that the relevant control objective has been achieved or the control tested has subsequently been removed from the service organization's description of its system.
- Information about causative factors for identified deviations, to the extent the service auditor has identified such factors.

Modified Opinions (Ref: Para. 55)

A50. Illustrative examples of elements of modified service auditor's assurance reports are contained in **Appendix 3**.

A51. Even if the service auditor has expressed an adverse opinion or disclaimed an opinion, it may be appropriate to describe in the basis for modification paragraph the reasons for any other matters of which the service auditor is aware that would have required a modification to the opinion, and the effects thereof.

A52. When expressing a disclaimer of opinion because of a scope limitation, it is not ordinarily appropriate to identify the procedures that were performed nor include statements describing the characteristics of a service auditor's engagement; to do so might overshadow the disclaimer of opinion.

Other Communication Responsibilities (Ref: Para. 56)

A53. Appropriate actions to respond to the circumstances identified in paragraph 56 may include:

- Obtaining legal advice about the consequences of different courses of action.
- Communicating with those charged with governance of the service organization.

¹⁵ SQC 1, paragraph 74.

¹⁶ SQC 1, paragraph 75.

I.724 Auditing Pronouncements

- Communicating with third parties (for example, a regulator) when required to do so.
- Modifying the service auditor's opinion, or adding an Other Matter paragraph.
- Withdrawing from the engagement.

Appendix 1

(Ref. Para. A47)

Example Service Organization's Assertions

The following examples of service organization's assertions are for guidance only and are not intended to be exhaustive or applicable to all situations.

Example 1: Type 2 Service Organization's Assertion

Assertion by the Service Organization

The accompanying description has been prepared for customers who have used [the type or name of] system and their auditors who have a sufficient understanding to consider the description, along with other information including information about controls operated by customers themselves, when assessing the risks of material misstatements of customers' financial statements. [Entity's name] confirms that:

- (a) The accompanying description at pages [bb-cc] fairly presents [the type or name of] system for processing customers' transactions throughout the period [date] to [date]. The criteria used in making this assertion were that the accompanying description:
 - (i) Presents how the system was designed and implemented, including:
 - The types of services provided, including, as appropriate, classes of transactions processed.
 - The procedures, within both information technology and manual systems, by which those transactions were initiated, recorded, processed, corrected as necessary, and transferred to the reports prepared for customers.
 - The related accounting records, supporting information and specific accounts that were used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information was transferred to the reports prepared for customers.
 - How the system dealt with significant events and conditions, other than transactions.
 - The process used to prepare reports for customers.
 - Relevant control objectives and controls designed to achieve those objectives.
 - Controls that we assumed, in the design of the system, would be implemented by user entities, and which, if necessary to achieve control objectives stated in the accompanying description, are identified in the description along with the specific control objectives that cannot be achieved by ourselves alone.
 - Other aspects of our control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that were relevant to processing and reporting customers' transactions.

- (ii) Includes relevant details of changes to the service organization's system during the period [date] to [date].
 - (iii) Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment.
- (b) The controls related to the control objectives stated in the accompanying description were suitably designed and operated effectively throughout the period [date] to [date]. The criteria used in making this assertion were that:
- (i) The risks that threatened achievement of the control objectives stated in the description were identified;
 - (ii) The identified controls would, if operated as described, provide reasonable assurance that those risks did not prevent the stated control objectives from being achieved; and
 - (iii) The controls were consistently applied as designed, including that manual controls were applied by individuals who have the appropriate competence and authority, throughout the period [date] to [date].

Example 2: Type 1 Service Organization's Assertion

The accompanying description has been prepared for customers who have used [the type or name of] system and their auditors who have a sufficient understanding to consider the description, along with other information including information about controls operated by customers themselves, when obtaining an understanding of customers' information systems relevant to financial reporting. [Entity's name] confirms that:

- (a) The accompanying description at pages [bb-cc] fairly presents [the type or name of] system for processing customers' transactions as at [date]. The criteria used in making this assertion were that the accompanying description:
- (i) Presents how the system was designed and implemented, including:
 - The types of services provided, including, as appropriate, classes of transactions processed.
 - The procedures, within both information technology and manual systems, by which those transactions were initiated, recorded, processed, corrected as necessary, and transferred to the reports prepared for customers.
 - The related accounting records, supporting information and specific accounts that were used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports prepared customers.
 - How the system dealt with significant events and conditions, other than transactions.
 - The process used to prepare reports for customers.
 - Relevant control objectives and controls designed to achieve those objectives.
 - Controls that we assumed, in the design of the system, would be implemented by user entities, and which, if necessary to achieve control objectives stated in the accompanying description, are identified in the description along with the specific control objectives that cannot be achieved by ourselves alone.

I.726 Auditing Pronouncements

- Other aspects of our control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that were relevant to processing and reporting customers' transactions.
- (ii) Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment.
- (b) The controls related to the control objectives stated in the accompanying description were suitably designed as at [date]. The criteria used in making this assertion were that:
- (i) The risks that threatened achievement of the control objectives stated in the description were identified; and
- (ii) The identified controls would, if operated as described, provide reasonable assurance that those risks did not prevent the stated control objectives from being achieved.

Appendix 2

(Ref. Para. A47)

Example Service Auditor's Assurance Reports

The following examples of reports are for guidance only and are not intended to be exhaustive or applicable to all situations.

Example 1: Type 2 Service Auditor's Assurance Report

Independent Service Auditor's Assurance Report on the Description of Controls, their Design and Operating Effectiveness

To: XYZ Service Organization

Scope

We have been engaged to report on XYZ Service Organization's description at pages [bb-cc] of its [type or name of] system for processing customers' transactions throughout the period [date] to [date] (the description), and on the design and operation of controls related to the control objectives stated in the description¹⁷.

XYZ Service Organization's Responsibilities

XYZ Service Organization is responsible for: preparing the description and accompanying assertion at page [aa], including the completeness, accuracy and method of presentation of the description and assertion; providing the services covered by the description; stating the control objectives; and designing, implementing and effectively operating controls to achieve the stated control objectives.

Service Auditor's Responsibilities

Our responsibility is to express an opinion on XYZ Service Organization's description and on the design and operation of controls related to the control objectives stated in that description, based on our procedures. We conducted our engagement in accordance with Standard on Assurance Engagements 3402, "Assurance

¹⁷ If some elements of the description are not included in the scope of the engagement, this is made clear in the assurance report.

Reports on Controls at a Service Organization,” issued by the Institute of Chartered Accountants of India. That standard requires that we comply with ethical requirements and plan and perform our procedures to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls are suitably designed and operating effectively.

An assurance engagement to report on the description, design and operating effectiveness of controls at a service organization involves performing procedures to obtain evidence about the disclosures in the service organization’s description of its system, and the design and operating effectiveness of controls. The procedures selected depend on the service auditor’s judgment, including the assessment of the risks that the description is not fairly presented, and that controls are not suitably designed or operating effectively. Our procedures included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the control objectives stated in the description were achieved. An assurance engagement of this type also includes evaluating the overall presentation of the description, the suitability of the objectives stated therein, and the suitability of the criteria specified by the service organization and described at page [aa].

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Limitations of Controls at a Service Organization

XYZ Service Organization’s description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment. Also, because of their nature, controls at a service organization may not prevent or detect all errors or omissions in processing or reporting transactions. Also, the projection of any evaluation of effectiveness to future periods is subject to the risk that controls at a service organization may become inadequate or fail.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:

- (a) The description fairly presents the [the type or name of] system as designed and implemented throughout the period from [date] to [date];
- (b) The controls related to the control objectives stated in the description were suitably designed throughout the period from [date] to [date]; and
- (c) The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period from [date] to [date].

Description of Tests of Controls

The specific controls tested and the nature, timing and results of those tests are listed on pages [yy-zz].

Intended Users and Purpose

This report and the description of tests of controls on pages [yy-zz] are intended only for customers who have used XYZ Service Organization’s [type or name of] system, and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when assessing the risks of material misstatements of customers’ financial statements.

I.728 Auditing Pronouncements

For XYZ and Co.
Chartered Accountants
Firm's Registration Number
Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁸)
Membership Number

Place of Signature

Date

Example 2: Type 1 Service Auditor's Assurance Report

Independent Service Auditor's Assurance Report on the Description of Controls and their Design

To: XYZ Service Organization

Scope

We have been engaged to report on XYZ Service Organization's description at pages [bb-cc] of its [type or name of] system for processing customers' transactions as at [date] (the description), and on the design of controls related to the control objectives stated in the description¹⁹.

We did not perform any procedures regarding the operating effectiveness of controls included in the description and, accordingly, do not express an opinion thereon.

XYZ Service Organization's Responsibilities

XYZ Service Organization is responsible for: preparing the description and accompanying assertion at page [aa], including the completeness, accuracy and method of presentation of the description and the assertion; providing the services covered by the description; stating the control objectives; and designing, implementing and effectively operating controls to achieve the stated control objectives.

Service Auditor's Responsibilities

Our responsibility is to express an opinion on XYZ Service Organization's description and on the design of controls related to the control objectives stated in that description, based on our procedures. We conducted our engagement in accordance with Standard on Assurance Engagements 3402, "Assurance Reports on Controls at a Service Organization," issued by the Institute of Chartered Accountants of India. That standard requires that we comply with ethical requirements and plan and perform our procedures to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls are suitably designed in all material respects.

An assurance engagement to report on the description and design of controls at a service organization involves performing procedures to obtain evidence about the disclosures in the service organization's description of its system, and the design of controls. The procedures selected depend on the service auditor's judgment, including the assessment that the description is not fairly presented, and that controls are not suitably designed. An assurance engagement of this type also includes evaluating the overall presentation of the description, the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page [aa].

¹⁸ Partner or Proprietor, as the case may be.

¹⁹ If some elements of the description are not included in the scope of the engagement, this is made clear in the assurance report.

As noted above, we did not perform any procedures regarding the operating effectiveness of controls included in the description and, accordingly, do not express an opinion thereon.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Limitations of Controls at a Service Organization

XYZ Service Organization's description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment. Also, because of their nature, controls at a service organization may not prevent or detect all errors or omissions in processing or reporting transactions.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:

- (a) The description fairly presents the [the type or name of] system as designed and implemented as at [date]; and
- (b) The controls related to the control objectives stated in the description were suitably designed as at [date].

Intended Users and Purpose

This report is intended only for customers who have used XYZ Service Organization's [type or name of] system, and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when obtaining an understanding of customers' information systems relevant to financial reporting.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation²⁰)
Membership Number

Place of Signature

Date

²⁰ Partner or Proprietor, as the case may be.

Appendix 3

(Ref. Para. A50)

Example Modified Service Auditor's Assurance Reports

The following examples of modified reports are for guidance only and are not intended to be exhaustive or applicable to all situations. They are based on the examples of reports in **Appendix 2**.

Example 1: Qualified opinion – the service organization's description of the system is not fairly presented in all material respects

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

The accompanying description states at page [mn] that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on our procedures, which included inquiries of staff personnel and observation of activities, we have determined that operator identification numbers and passwords are employed in Applications A and B but not in Applications C and D.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization's assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

Example 2: Qualified opinion – the controls are not suitably designed to provide reasonable assurance that the control objectives stated in the service organization's description of its system will be achieved if the controls operate effectively

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

As discussed at page [mn] of the accompanying description, from time to time XYZ Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes and in implementing them, do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization's assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

Example 3: Qualified opinion – the controls did not operate effectively throughout the specified period (type 2 report only)

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, as noted at page [mn] of the description, this control was not operating effectively during the period from dd/mm/yyyy to dd/mm/yyyy due to a programming error. This resulted in the non-achievement of the control objective "Controls provide reasonable assurance that loan payments received are properly recorded" during the period from dd/mm/yyyy to dd/mm/yyyy. XYZ implemented a change to the program performing the calculation as of [date], and our tests indicate that it was operating effectively during the period from dd/mm/yyyy to dd/mm/yyyy.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization's assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

...

Example 4: Qualified opinion – the service auditor is unable to obtain sufficient appropriate evidence

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, electronic records of the performance of this reconciliation for the period from dd/mm/yyyy to dd/mm/yyyy were deleted as a result of a computer processing error, and we were therefore unable to test the operation of this control for that period. Consequently, we were unable to determine whether the control objective "Controls provide reasonable assurance that loan payments received are properly recorded" operated effectively during the period from dd/mm/yyyy to dd/mm/yyyy.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization's assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

SAE 3420

**Engagements to Report on the Compilation of Pro
Forma Financial Information Included in a
Prospectus**
*(Effective in relation to reports on
projections/forecasts issued on or after April 1, 2016)*

Introduction

Scope of this SAE

1. This Standard on Assurance Engagements (SAE) deals with reasonable assurance engagements undertaken by a practitioner¹ to report on the responsible party's² compilation of pro forma financial information included in a prospectus. The SAE applies where:

- Such reporting is required by securities law or the regulation of the securities exchange ("relevant law or regulation") in the jurisdiction in which the prospectus is to be issued; or
- This reporting is generally accepted practice in such jurisdiction. (Ref: Para. A1)

Nature of the Practitioner's Responsibility

2. In an engagement performed under this SAE, the practitioner has no responsibility to compile the pro forma financial information for the entity; such responsibility rests with the responsible party. The practitioner's sole responsibility is to report on whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

3. This SAE does not deal with non-assurance engagements in which the practitioner is engaged by the entity to compile its historical financial statements.

Purpose of Pro Forma Financial Information Included in a Prospectus

4. The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. This is achieved by applying pro forma adjustments to the unadjusted financial information. Pro forma financial information does not represent the entity's actual financial position, financial performance, or cash flows. (Ref: Para. A2–A3)

Compilation of Pro Forma Financial Information

5. The compilation of pro forma financial information involves the responsible party gathering, classifying, summarizing and presenting financial information that illustrates the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at the selected date. Steps involved in this process include:

- Identifying the source of the unadjusted financial information to be used in compiling the pro forma

¹ The term "practitioner" is described in the Framework for Assurance Engagements, paragraphs 1, 22 and 23.

² The Framework for Assurance Engagements, paragraph 24, describes the meaning of the term "responsible party."

financial information, and extracting the unadjusted financial information from that source; (Ref: Para. A4–A5)

- Making pro forma adjustments to the unadjusted financial information for the purpose for which the pro forma financial information is presented; and
- Presenting the resulting pro forma financial information with accompanying disclosures.

6. A reasonable assurance engagement to report on the compilation of pro forma financial information involves performing the procedures set out in this SAE to assess whether the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether: (Ref: Para. A6)

- The related pro forma adjustments give appropriate effect to those criteria; and
- The resulting pro forma column (see paragraph 11(c)) reflects the proper application of those adjustments to the unadjusted financial information.

It also involves evaluating the overall presentation of the pro forma financial information. The engagement, however, does not involve the practitioner updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, or performing an audit or review of the financial information used in compiling the pro forma financial information.

Relationship with Other Professional Pronouncements

7. The performance of assurance engagements other than audits or reviews of historical financial information requires the practitioner to comply with the Framework for Assurance Engagements. The Framework includes requirements in relation to such topics as engagement acceptance, planning, evidence, and documentation that apply to all assurance engagements, including engagements in accordance with this SAE. This SAE expands on how the Framework is to be applied in a reasonable assurance engagement to report on the compilation of pro forma financial information included in a prospectus. The Framework also defines and describes the elements and objectives of an assurance engagement, provides context for understanding this SAE.

8. Compliance with the Framework requires, among other things, that the practitioner:
- Comply with the independence and other requirements of the Code of Ethics, issued by the Institute of Chartered Accountants of India; and
 - Implement quality control procedures that are applicable to the individual engagement.

Effective Date

9. This SAE is effective for assurance reports dated on or after 01st April 2016.

Objectives

10. The objectives of the practitioner are:
- (a) To obtain reasonable assurance about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria; and
 - (b) To report in accordance with the practitioner's findings.

Definitions

11. For purposes of this SAE, the following terms have the meanings attributed below:
- (a) Applicable criteria – The criteria used by the responsible party when compiling the pro forma financial

I.734 Auditing Pronouncements

information. Criteria may be established by an authorized or recognized standard-setting organization or by law or regulation. Where established criteria do not exist, they will be developed by the responsible party. (Ref: Para. A7–A9)

- (b) Pro forma adjustments – In relation to unadjusted financial information, these include:
- (i) Adjustments to unadjusted financial information that illustrate the impact of a significant event or transaction (“event” or “transaction”) as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration; and
 - (ii) Adjustments to unadjusted financial information that are necessary for the pro forma financial information to be compiled on a basis consistent with the applicable financial reporting framework of the reporting entity (“entity”) and its accounting policies under that framework. (Ref: Para. A15–A16)

Pro forma adjustments include the relevant financial information of a business that has been, or is to be, acquired (“acquiree”), or a business that has been, or is to be, divested (“divestee”), to the extent that such information is used in compiling the pro forma financial information (“acquiree or divestee financial information”).

- (c) Pro forma financial information – Financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. In this SAE, it is presumed that pro forma financial information is presented in columnar format consisting of (a) the unadjusted financial information; (b) the pro forma adjustments; and (c) the resulting pro forma column. (Ref: Para. A2)
- (d) Prospectus – A document issued pursuant to legal or regulatory requirements relating to the entity’s securities on which it is intended that a third party should make an investment decision.
- (e) Published financial information – Financial information of the entity or of an acquiree or a divestee that is made available publicly.
- (f) Unadjusted financial information – Financial information of the entity to which pro forma adjustments are applied by the responsible party. (Ref: Para. A4–A5)

Requirements

Framework for Assurance Engagements

12. The practitioner shall not represent compliance with this SAE unless the practitioner has complied with the requirements of both this SAE and the Framework for Assurance Engagements.

Engagement Acceptance

13. Before agreeing to accept an engagement to report on whether pro forma financial information included in a prospectus has been compiled, in all material respects, on the basis of the applicable criteria, the practitioner shall:

- (a) Determine that the practitioner has the capabilities and competence to perform the engagement; (Ref: Para. A10)
- (b) On the basis of a preliminary knowledge of the engagement circumstances and discussion with the responsible party, determine that the applicable criteria are suitable and that it is unlikely that the pro forma financial information will be misleading for the purpose for which it is intended;
- (c) Evaluate the wording of the opinion prescribed by the relevant law or regulation, if any, to determine that the practitioner will likely be able to express the opinion so prescribed based on performing the

procedures specified in this SAE; (Ref: Para. A54–A56)

- (d) Where the sources from which the unadjusted financial information and any acquiree or divestee financial information have been extracted have been audited or reviewed and a modified audit opinion or review conclusion has been expressed, or the report contains an Emphasis of Matter paragraph, consider whether or not the relevant law or regulation permits the use of, or reference in the practitioner's report to, the modified audit opinion or review conclusion or the report containing the Emphasis of Matter paragraph with respect to such sources;
- (e) If the entity's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the entity and its accounting and financial reporting practices to perform the engagement; (Ref: Para. A31)
- (f) If the event or transaction includes an acquisition and the acquiree's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the acquiree and its accounting and financial reporting practices to perform the engagement; and
- (g) Obtain the agreement of the responsible party that it acknowledges and understands its responsibility for: (Ref: Para. A11–A12)
 - (i) Adequately disclosing and describing the applicable criteria to the intended users if these are not publicly available;
 - (ii) Compiling the pro forma financial information on the basis of the applicable criteria; and
 - (iii) Providing the practitioner with:
 - a. Access to all information (including, when needed for purposes of the engagement, information of the acquiree(s) in a business combination), such as records, documentation and other material, relevant to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria;
 - b. Additional information that the practitioner may request from the responsible party for the purpose of the engagement;
 - c. Access to those within the entity and the entity's advisors from whom the practitioner determines it necessary to obtain evidence relating to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; and
 - d. When needed for purposes of the engagement, access to appropriate individuals within the acquiree(s) in a business combination.

Planning and Performing the Engagement

Assessing the Suitability of the Applicable Criteria

14. The practitioner shall assess whether the applicable criteria are suitable, as required by the Framework for Assurance Engagements³, and in particular shall determine that they include, at a minimum, that:

- (a) The unadjusted financial information be extracted from an appropriate source; (Ref: Para. A4–A5, A27)
- (b) The pro forma adjustments be:
 - (i) Directly attributable to the event or transaction; (Ref: Para. A13)
 - (ii) Factually supportable; and (Ref: Para. A14)

³ The Framework for Assurance Engagements, paragraph 16

I.736 Auditing Pronouncements

- (iii) Consistent with the entity's applicable financial reporting framework and its accounting policies under that framework; and (Ref: Para. A15–A16)
- (c) Appropriate presentation be made and disclosures be provided to enable the intended users to understand the information conveyed. (Ref: Para. A2–A3, A42)
- 15. In addition, the practitioner shall assess whether the applicable criteria are:
 - (a) Consistent, and do not conflict, with relevant law or regulation; and
 - (b) Unlikely to result in pro forma financial information that is misleading.

Materiality

16. When planning and performing the engagement, the practitioner shall consider materiality with respect to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria. (Ref: Para. A17–A18)

Obtaining an Understanding of How the Responsible Party Has Compiled the Pro Forma Financial Information and Other Engagement Circumstances

- 17. The practitioner shall obtain an understanding of: (Ref: Para. A19)
 - (a) The event or transaction in respect of which the pro forma financial information is being compiled;
 - (b) How the responsible party has compiled the pro forma financial information; (Ref: Para. A20–A21)
 - (c) The nature of the entity and any acquiree or divestee, including: (Ref: Para. A22–A23)
 - (i) Their operations;
 - (ii) Their assets and liabilities; and
 - (iii) The way they are structured and how they are financed;
 - (d) Relevant industry, legal and regulatory, and other external factors pertaining to the entity and any acquiree or divestee; and (Ref: Para. A24–A26)
 - (e) The applicable financial reporting framework and the accounting and financial reporting practices of the entity and of any acquiree or divestee, including their selection and application of accounting policies.

Obtaining Evidence about the Appropriateness of the Source from Which the Unadjusted Financial Information Has Been Extracted

18. The practitioner shall determine whether the responsible party has extracted the unadjusted financial information from an appropriate source. (Ref: Para. A27–A28)

19. If there is no audit or review report on the source from which the unadjusted financial information has been extracted, the practitioner shall perform procedures to be satisfied that the source is appropriate. (Ref: Para. A29–A31)

20. The practitioner shall determine whether the responsible party has appropriately extracted the unadjusted financial information from the source.

Obtaining Evidence about the Appropriateness of the Pro Forma Adjustments

21. In evaluating whether the pro forma adjustments are appropriate, the practitioner shall determine whether the responsible party has identified the pro forma adjustments necessary to illustrate the impact of the event or transaction at the date or for the period of the illustration. (Ref: Para. A32)

22. In determining whether the pro forma adjustments are in accordance with the applicable criteria, the practitioner shall determine whether they are:

- (a) Directly attributable to the event or transaction; (Ref: Para. A13)

- (b) Factually supportable. If acquiree or divestee financial information is included in the pro forma adjustments and there is no audit or review report on the source from which such financial information has been extracted, the practitioner shall perform procedures to be satisfied that the financial information is factually supportable; and (Ref: Para. A14, A33– A38)
- (c) Consistent with the entity's applicable financial reporting framework and its accounting policies under that framework. (Ref: Para. A15-A16)

Modified Audit Opinion or Review Conclusion, or Emphasis of Matter Paragraph, with Respect to the Source from Which the Unadjusted Financial Information Has Been Extracted or the Source from Which the Acquiree or Divestee Financial Information Has Been Extracted

23. A modified audit opinion or review conclusion may have been expressed with respect to either the source from which the unadjusted financial information has been extracted or the source from which the acquiree or divestee financial information has been extracted, or a report containing an Emphasis of Matter paragraph may have been issued with respect to such source. In such circumstances, if the relevant law or regulation does not prohibit the use of such a source, the practitioner shall evaluate:

- (a) The potential consequence on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; (Ref: Para. A39)
- (b) What further appropriate action to take; and (Ref: Para. A40)
- (c) Whether there is any effect on the practitioner's ability to report in accordance with the terms of the engagement, including any effect on the practitioner's report.

Source from Which the Unadjusted Financial Information Has Been Extracted or Pro Forma Adjustments Not Appropriate

24. If, on the basis of the procedures performed, the practitioner identifies that the responsible party has:

- (a) Used an inappropriate source from which to extract the unadjusted financial information; or
- (b) Omitted a pro forma adjustment that should be included, applied a pro forma adjustment that is not in accordance with the applicable criteria or otherwise inappropriately applied a pro forma adjustment,

the practitioner shall discuss the matter with the responsible party. If the practitioner is unable to agree with the responsible party as to how the matter should be resolved, the practitioner shall evaluate what further action to take. (Ref: Para. A40)

Obtaining Evidence about the Calculations within the Pro Forma Financial Information

25. The practitioner shall determine whether the calculations within the pro forma financial information are arithmetically accurate.

Evaluating the Presentation of the Pro Forma Financial Information

26. The practitioner shall evaluate the presentation of the pro forma financial information. This shall include consideration of:

- (a) The overall presentation and structure of the pro forma financial information, including whether it is clearly labeled to distinguish it from historical or other financial information; (Ref: Para. A2–A3)
- (b) Whether the pro forma financial information and related explanatory notes illustrate the impact of the event or transaction in a manner that is not misleading; (Ref: Para. A41)
- (c) Whether appropriate disclosures are provided with the pro forma financial information to enable the intended users to understand the information conveyed; and (Ref: Para. A42)
- (d) Whether the practitioner has become aware of any significant events subsequent to the date of the

I.738 Auditing Pronouncements

source from which the unadjusted financial information has been extracted that may require reference to, or disclosure in, the pro forma financial information. (Ref: Para. A43)

27. The practitioner shall read the other information included in the prospectus containing the pro forma financial information to identify material inconsistencies, if any, with the pro forma financial information. If, on reading the other information, the practitioner identifies a material inconsistency or becomes aware of a material misstatement of fact in that other information, the practitioner shall discuss the matter with the responsible party.

If correction of the matter is necessary and the responsible party refuses to do so, the practitioner shall take further appropriate action. (Ref: Para. A44)

Written Representations

28. The practitioner shall request written representations from the responsible party that:

- (a) In compiling the pro forma financial information, the responsible party has identified all appropriate pro forma adjustments necessary to illustrate the impact of the event or transaction at the date or for the period of the illustration; and (Ref: Para. A45)
- (b) The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

Forming the Opinion

29. The practitioner shall form an opinion on whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria. (Ref: Para. A46–A48)

30. In order to form that opinion, the practitioner shall conclude whether the practitioner has obtained sufficient appropriate evidence about whether the compilation of the pro forma financial information is free from material omissions, or inappropriate use or application of a pro forma adjustment. That conclusion shall include an evaluation of whether the responsible party has adequately disclosed and described the applicable criteria to the extent that these are not publicly available. (Ref: Para. A49–A50)

Form of Opinion

Unmodified Opinion

31. The practitioner shall express an unmodified opinion when the practitioner concludes that the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

Modified Opinion

32. Where the relevant law or regulation precludes publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the practitioner concludes that a modified opinion is nevertheless appropriate in accordance with the Framework for Assurance Engagements, the practitioner shall discuss the matter with the responsible party. If the responsible party does not agree to make the necessary changes, the practitioner shall:

- (a) Withdraw from the engagement; or
- (b) Consider seeking legal advice.

33. Where the relevant law or regulation may not preclude publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the practitioner determines that a modified opinion is

appropriate in accordance with the Framework for Assurance Engagements, the practitioner shall apply the requirements in the Framework for Assurance Engagements regarding modified opinions.

Emphasis of Matter Paragraph

34. In some circumstances, the practitioner may consider it necessary to draw users' attention to a matter presented or disclosed in the pro forma financial information or the accompanying explanatory notes. This would be the case when, in the practitioner's opinion, the matter is of such importance that it is fundamental to users' understanding of whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria. In such circumstances, the practitioner shall include an Emphasis of Matter paragraph in the practitioner's report provided that the practitioner has obtained sufficient appropriate evidence that the matter does not affect whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria. Such a paragraph shall refer only to information presented or disclosed in the pro forma financial information or the accompanying explanatory notes.

Preparing the Assurance Report

35. The practitioner's report shall include the following basic elements: (Ref: Para. A57)

- (a) A title that clearly indicates that the report is an independent assurance report; (Ref: Para. A51)
- (b) An addressee(s), as agreed in the terms of engagement; (Ref: Para. A52)
- (c) Introductory paragraphs that identify: (Ref: Para. A53)
 - (i) The pro forma financial information;
 - (ii) The source from which the unadjusted financial information has been extracted, and whether or not an audit or review report on such a source has been published;
 - (iii) The period covered by, or the date of, the pro forma financial information; and
 - (iv) A reference to the applicable criteria on the basis of which the responsible party has performed the compilation of the pro forma financial information, and the source of the criteria;
- (d) A statement that the responsible party is responsible for compiling the pro forma financial information on the basis of the applicable criteria;
- (e) A description of the practitioner's responsibilities, including statements that:
 - (i) The practitioner's responsibility is to express an opinion about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria;
 - (ii) For purposes of this engagement, the practitioner is not responsible for updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor has the practitioner, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information; and
 - (iii) The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. Accordingly, the practitioner does not provide any assurance that the actual outcome of the event or transaction at that date would have been as presented;
- (f) A statement that the engagement was performed in accordance with SAE 3420, 'Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a

I.740 Auditing Pronouncements

Prospectus, which requires that the practitioner comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether the responsible party has compiled, in all material respects, the pro forma financial information on the basis of the applicable criteria;

- (g) Statements that:
- (i) A reasonable assurance engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether:
 - The related pro forma adjustments give appropriate effect to those criteria; and
 - The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information;
 - (ii) The procedures selected depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the entity, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances; and
 - (iii) The engagement also involves evaluating the overall presentation of the pro forma financial information;
- (h) Unless otherwise required by law or regulation, the practitioner's opinion using one of the following phrases, which are regarded as being equivalent: (Ref: Para. A54–A56)
- (i) The pro forma financial information has been compiled, in all material respects, on the basis of the [applicable criteria]; or
 - (ii) The pro forma financial information has been properly compiled on the basis stated;
- (i) The practitioner's signature;
 - (j) The date of the report; and
 - (k) The place of signature.

Application and Other Explanatory Material

Scope of this SAE (Ref: Para.1)

A1. *This standard does not deal with circumstances where pro forma financial information is provided as part of the entity's financial statements pursuant to the requirements of an applicable financial reporting framework.*

Purpose of Pro Forma Financial Information Included in a Prospectus

(Ref: Para. 4, 11(c), 14(c), 26(a))

A2. *Pro forma financial information is accompanied by related explanatory notes that often disclose the matters set out in paragraph A42.*

A3. *Different presentations of pro forma financial information may be included in the prospectus depending on the nature of the event or transaction and how the responsible party intends to illustrate the impact of such event or transaction on the unadjusted financial information of the entity. For example, the entity may acquire a number of businesses prior to an initial public offering. In such circumstances, the responsible party may choose to present a pro forma net asset statement to illustrate the impact of the*

acquisitions on the entity's financial position and key ratios such as debt to equity as if the acquired businesses had been combined with the entity at an earlier date. The responsible party may also choose to present a pro forma income statement to illustrate what the results of operations might have been for the period ended on that date. In such cases, the nature of the pro forma financial information may be described by titles such as "Pro Forma Balance Sheet as at March 31, 20X1" and "Pro Forma Statement of profit and loss for the Year Ended March 31, 20X1."

Compilation of Pro Forma Financial Information

Unadjusted Financial Information (Ref: Para. 5, 11(f), 14(a))

A4. In many cases, the source from which the unadjusted financial information has been extracted will be published financial information such as annual or interim financial statements.

A5. Depending on how the responsible party chooses to illustrate the impact of the event or transaction, the unadjusted financial information may comprise either:

- One or more single financial statements, such as a statement of financial position and a statement of profit and loss; or
- Financial information that is appropriately condensed from a complete set of financial statements, for example, a statement of net assets.

Nature of Reasonable Assurance Engagement (Ref: Para. 6)

A6. In this SAE, describing the pro forma financial information as being "properly compiled" means that the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

Definitions

Applicable Criteria (Ref: Para. 11(a))

A7. Where established criteria for compiling the pro forma financial information do not exist, the responsible party will have developed the criteria based on, for example, practice in a particular industry or the criteria of a jurisdiction that has developed established criteria, and disclosed that fact.

A8. The applicable criteria for compiling the pro forma financial information will be suitable in the circumstances if they meet the benchmarks set out in paragraph 14.

A9. Accompanying explanatory notes may include appropriate additional detail about the criteria to describe how they illustrate the effects of the particular event or transaction. This may include, for example:

- The date at which the event is assumed to have occurred or the transaction been undertaken.
- The approach used for allocating income, overheads, assets and liabilities between relevant businesses in a divestment.

Engagement Acceptance

Capabilities and Competence to Perform the Engagement (Ref: Para. 13(a))

A10. The Code of Ethics, issued by the Institute of Chartered Accountants of India requires the practitioner to maintain appropriate professional knowledge and skill, including an awareness and understanding of relevant technical, professional and business developments, in order to provide competent professional service⁴. In the context of this requirement of the Code of Ethics, relevant capabilities and competence to perform the engagement also include matters such as the following:

⁴ The Code of Ethics, paragraphs 130.1-130.3.

I.742 Auditing Pronouncements

- Knowledge and experience of the industry in which the entity operates;
- An understanding of the relevant securities laws and regulations and related developments;
- An understanding of the listing requirements of the relevant securities exchange and of capital market transactions such as mergers, acquisitions and securities offerings;
- Familiarity with the process of preparing a prospectus and listing securities on the securities exchange; and
- Knowledge of the financial reporting frameworks used in the preparation of the sources from which the unadjusted financial information and, if applicable, the acquiree's financial information have been extracted.

The Responsible Party's Responsibilities (Ref: Para. 13(g))

A11. *An engagement in accordance with this SAE is conducted on the premise that the responsible party has acknowledged and understands that it has the responsibilities set out in paragraph 13(g). In some jurisdictions, such responsibilities may be specified in the relevant law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. An assurance engagement to report on whether pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria is based on the assumption that:*

- (a) The practitioner's role does not involve taking responsibility for compiling such information; and
- (b) The practitioner has a reasonable expectation of obtaining the information necessary for the engagement.

Accordingly, this premise is fundamental to the conduct of the engagement. To avoid misunderstanding, agreement is reached with the responsible party that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the engagement as required by the Framework for Assurance Engagements.

A12. *If law or regulation prescribes in sufficient detail the terms of the engagement, the practitioner need only record the fact that such law or regulation applies and that the responsible party acknowledges and understands its responsibilities as set out in paragraph 13(g).*

Planning and Performing the Engagement Assessing the Suitability of the Applicable Criteria Directly Attributable Adjustments (Ref: Para. 14(b)(i), 22(a))

A13. *It is necessary that the pro forma adjustments be directly attributable to the event or transaction to avoid the pro forma financial information reflecting matters that do not arise solely as a result of the event or that are not an integral part of the transaction. Directly attributable adjustments exclude those that relate to future events or are dependent on actions to be taken once the transaction has been completed, even if such actions are key to the entity entering into the transaction (for example, closing of redundant production sites after an acquisition).*

Factually Supportable Adjustments (Ref: Para. 14(b)(ii), 22(b))

A14. *It is also necessary that the pro forma adjustments be factually supportable in order to provide a reliable basis for the pro forma financial information. Factually supportable adjustments are capable of objective determination. Sources of factual support for the pro forma adjustments include, for example:*

- Purchase and sale agreements.
- Financing documents for the event or transaction, such as debt agreements.
- Independent valuation reports.

- Other documents relating to the event or transaction.
- Published financial statements.
- Other financial information disclosed in the prospectus.
- Relevant legal or regulatory actions, such as in the area of taxation.
- Employment agreements.
- Actions of those charged with governance.

Adjustments Consistent with the Entity's Applicable Financial Reporting Framework and Its Accounting Policies under that Framework (Ref: Para. 11(b)(ii), 14(b)(iii), 22(c))

A15. For the pro forma financial information to be meaningful, it is necessary that the pro forma adjustments be consistent with the entity's applicable financial reporting framework and its accounting policies under that framework. In the context of a business combination, for example, compiling the pro forma financial information on the basis of the applicable criteria involves consideration of such matters as:

- Whether differences exist between the acquiree's accounting policies and those of the entity; and
- Whether accounting policies for transactions undertaken by the acquiree that the entity has not previously entered into are policies that the entity would have adopted for such transactions under its applicable financial reporting framework, taking into account the entity's particular circumstances.

A16. Consideration of the appropriateness of the entity's accounting policies may also be necessary in some circumstances. For example, as part of the event or transaction, the entity may propose to issue complex financial instruments for the first time. If this is the case, it may be necessary to consider:

- Whether the responsible party has selected appropriate accounting policies to be used in accounting for such financial instruments under its applicable financial reporting framework; and
- Whether it has appropriately applied such policies in compiling the pro forma financial information.

Materiality (Ref: Para. 16)

A17. Materiality with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria does not depend on a single quantitative measure. Instead, it depends on the size and nature of the omission or inappropriate application of an element of the compilation as described in paragraph A18, whether or not intentional. Judgment about these aspects of size and nature will, in turn, depend on such matters as:

- The context of the event or transaction;
- The purpose for which the pro forma financial information is being compiled; and
- The related engagement circumstances.

The determining factor could be the size or the nature of the matter, or a combination of both.

A18. The risk of the pro forma financial information not being considered compiled, in all material respects, on the basis of the applicable criteria may arise when there is evidence of, for example:

- Use of an inappropriate source from which to extract the unadjusted financial information.
- Incorrect extraction of the unadjusted financial information from an appropriate source.
- In relation to adjustments, the misapplication of accounting policies or the failure of the adjustments to be consistent with the entity's accounting policies.
- Failure to make an adjustment required by the applicable criteria.

I.744 Auditing Pronouncements

- Making an adjustment that is not in accordance with the applicable criteria.
- A mathematical or clerical mistake in the calculations within the pro forma financial information.
- Inadequate, incorrect or omitted disclosures.

Obtaining an Understanding of How the Responsible Party Has Compiled the Pro Forma Financial Information and Other Engagement Circumstances (Ref: Para. 17)

A19. *The practitioner may obtain this understanding through a combination of procedures such as:*

- Inquiring of the responsible party and other entity personnel involved in compiling the pro forma financial information.
- Inquiring of other appropriate parties such as those charged with governance and the entity's advisors.
- Reading relevant supporting documentation such as contracts or agreements.
- Reading minutes of meetings of those charged with governance.

How the Responsible Party Has Compiled the Pro Forma Financial Information (Ref: Para. 17(b))

A20. *The practitioner may obtain an understanding of how the responsible party has compiled the pro forma financial information by considering, for example:*

- The source from which the unadjusted financial information has been extracted.
- The steps taken by the responsible party to:
 - Extract the unadjusted financial information from the source.
 - Identify the appropriate pro forma adjustments, for example, how the responsible party has obtained acquiree financial information in compiling the pro forma financial information.
- The responsible party's competence in compiling pro forma financial information.
- The nature and extent of oversight by the responsible party of other entity personnel involved in compiling the pro forma financial information.
- The responsible party's approach to identifying appropriate disclosures to support the pro forma financial information.

A21. *In a business combination or divestment, areas that may give rise to complexity in the compilation of the pro forma financial information include allocations of income, overheads, and assets and liabilities among or between the relevant businesses. Accordingly, it is important that the practitioner understand the responsible party's approach and criteria for such allocations and that the explanatory notes accompanying the pro forma financial information disclose these matters.*

Nature of the Entity and Any Acquiree or Divestee (Ref: Para. 17(c))

A22. *An acquiree may be an incorporated entity or a separately identifiable unincorporated operation within another entity such as a division, branch or line of business. A divestee may be an incorporated entity such as a subsidiary or joint venture, or a separately identifiable unincorporated operation within the entity such as a division, branch or line of business.*

A23. *The practitioner may have all or part of the required understanding of the entity and any acquiree or divestee, and their respective environments, if the practitioner has audited or reviewed their financial information.*

Relevant Industry, Legal and Regulatory, and Other External Factors (Ref: Para. 17(d))

A24. *Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the practitioner may*

consider include:

- The market and competition, including demand, capacity, and price competition.
- Common business practices within the industry.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.

A25. *Relevant legal and regulatory factors include the legal and regulatory environment. This encompasses, among other matters, the applicable financial reporting framework in accordance with which the entity or, if applicable, the acquiree prepares its periodic financial information, and the legal and political environment. Examples of matters the practitioner may consider include:*

- Industry-specific accounting practices.
- Legal and regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's or, if applicable, the acquiree's or divestee's operations, including direct supervisory activities.
- Taxation.
- Government policies currently affecting the conduct of the entity's or, if applicable, the acquiree's or divestee's business, such as monetary policies (including foreign exchange controls), fiscal policies, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the entity's or acquiree's or divestee's industry and business.

A26. *Examples of other external factors affecting the entity and, if applicable, the acquiree or divestee that the practitioner may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.*

Obtaining Evidence about the Appropriateness of the Source from Which the Unadjusted Financial Information Has Been Extracted

Relevant Factors to Consider (Ref: Para. 14(a), 18)

A27. *Factors that affect the appropriateness of the source from which the unadjusted financial information has been extracted include whether there is an audit or review report on the source and whether the source:*

- Is permitted or specifically prescribed by the relevant law or regulation, is permitted by the relevant securities exchange with which the prospectus is to be filed, or is used as such under normal market custom and practice.
- Is clearly identifiable.
- Represents a reasonable starting point for compiling the pro forma financial information in the context of the event or transaction, including whether it is consistent with the entity's accounting policies and is at an appropriate date or covers an appropriate period.

A28. *An audit or review report on the source from which the unadjusted financial information has been extracted may have been issued by another practitioner. In this situation, the need by the practitioner reporting under this SAE for an understanding of the entity and its accounting and financial reporting practices pursuant to the requirements of paragraphs 17(c) and (e), and to be satisfied that the source from which the unadjusted financial information has been extracted is appropriate, is not diminished.*

No Audit or Review Report on the Source from Which the Unadjusted Financial Information Has Been Extracted (Ref: Para. 19)

I.746 Auditing Pronouncements

A29. When there is no audit or review report on the source from which the unadjusted financial information has been extracted, it is necessary for the practitioner to perform procedures in relation to the appropriateness of that source. Factors that may affect the nature and extent of these procedures include, for example:

- Whether the practitioner has previously audited or reviewed the entity's historical financial information, and the practitioner's knowledge of the entity from such engagement.
- How recently the entity's historical financial information was audited or reviewed.
- Whether the entity's financial information is subject to periodic review by the practitioner, for example, for purposes of meeting regulatory filing requirements.

A30. The entity's financial statements for the period immediately preceding that of the source from which the unadjusted financial information has been extracted are likely to have been audited or reviewed, even if the source from which the unadjusted financial information has been extracted itself is not. For example, the source from which the unadjusted financial information has been extracted may be interim financial statements that have not been audited or reviewed whereas the entity's financial statements for the immediately preceding financial year may have been audited. In such a case, procedures that the practitioner may perform, having regard to the factors in paragraph A29, in relation to the appropriateness of the source from which the unadjusted financial information has been extracted include:

- Inquiring of the responsible party about:
 - The process by which the source has been prepared and the reliability of the underlying accounting records to which the source is agreed or reconciled.
 - Whether all transactions have been recorded.
 - Whether the source has been prepared in accordance with the entity's accounting policies.
 - Whether there have been any changes in accounting policies from the most recent audited or reviewed period and, if so, how such changes have been dealt with.
 - Its assessment of the risk that the source may be materially misstated as a result of fraud.
 - The effect of changes in the entity's business activities and operations.
- If the practitioner has audited or reviewed the immediately preceding annual or interim financial information, considering the findings of such audit or review and whether these might indicate any issues with the preparation of the source from which the unadjusted financial information has been extracted.
- Corroborating the information provided by the responsible party in response to the practitioner's inquiries when the responses appear inconsistent with the practitioner's understanding of the entity or the engagement circumstances.
- Comparing the source with the corresponding prior period financial information and, as applicable, the immediately preceding annual or interim financial information, and discussing significant changes with the responsible party.

Historical financial information of the entity never audited or reviewed (Ref: Para. 13(e))

A31. Other than in the case of an entity formed for purposes of the transaction and which has never had any trading activity, it is unlikely that relevant law or regulation will permit an entity to issue a prospectus if its historical financial information has never been audited or reviewed.

Obtaining Evidence about the Appropriateness of the Pro Forma Adjustments *Identification of Appropriate Pro Forma Adjustments (Ref: Para. 21)*

A32. Informed by the practitioner's understanding of how the responsible party has compiled the pro forma financial information and other engagement circumstances, the practitioner may obtain evidence regarding whether the responsible party has appropriately identified the necessary pro forma adjustments through a combination of procedures such as:

- Evaluating the reasonableness of the responsible party's approach to identifying the appropriate pro forma adjustments, for example, the method used in identifying appropriate allocations of income, overheads, assets and liabilities among the relevant businesses.
- Inquiring of relevant parties within an acquiree regarding the approach to extracting the acquiree financial information.
- Evaluating specific aspects of the relevant contracts, agreements or other documents.
- Inquiring of the entity's advisors regarding specific aspects of the event or transaction and related contracts and agreements that are relevant to the identification of appropriate adjustments.
- Evaluating relevant analyses and worksheets prepared by the responsible party and other entity personnel involved in compiling the pro forma financial information.
- Obtaining evidence of the responsible party's oversight of other entity personnel involved in compiling the pro forma financial information.
- Performing analytical procedures.

Factual Support for Any Acquiree or Divestee Financial Information Included in the Pro Forma Adjustments (Ref: Para. 22(b))

Divestee financial information

A33. In the case of a divestment, the divestee's financial information will be derived from the source from which the unadjusted financial information has been extracted, which will often be audited or reviewed. The source from which the unadjusted financial information has been extracted will therefore provide the basis for the practitioner to determine whether there is factual support for the divestee financial information. In such a case, matters to consider include, for example, whether income and expenses attributable to the divestee that are recorded at the consolidated level have been appropriately reflected in the pro forma adjustments.

A34. Where the source from which the unadjusted financial information has been extracted has not been audited or reviewed, the practitioner may refer to the guidance in paragraphs A29–A30 in determining whether the divestee financial information is factually supportable.

Acquiree financial information

A35. The source from which the acquiree financial information has been extracted may have been audited or reviewed. Where the source from which the acquiree financial information has been extracted has been audited or reviewed by the practitioner, the acquiree financial information will, subject to any implications arising from the circumstances addressed in paragraph 23, be factually supportable.

A36. The source from which the acquiree financial information has been extracted may have been audited or reviewed by another practitioner. In this situation, the need by the practitioner reporting under this SAE for an understanding of the acquiree and its accounting and financial reporting practices pursuant to the requirements of paragraphs 17(c) and (e), and to be satisfied that the acquiree financial information is factually supportable, is not diminished.

A37. When the source from which the acquiree financial information has been extracted has not been

I.748 Auditing Pronouncements

audited or reviewed, it is necessary for the practitioner to perform procedures in relation to the appropriateness of that source. Factors that may affect the nature and extent of these procedures include, for example:

- Whether the practitioner has previously audited or reviewed the acquiree's historical financial information, and the practitioner's knowledge of the acquiree from such engagement.
- How recently the acquiree's historical financial information was audited or reviewed.
- Whether the acquiree's financial information is subject to periodic review by the practitioner, for example, for purposes of meeting regulatory filing requirements.

A38. The acquiree's financial statements for the period immediately preceding that of the source from which the acquiree financial information has been extracted often will have been audited or reviewed, even if the source from which the acquiree financial information has been extracted itself is not. In such a case, procedures that the practitioner may perform, having regard to the factors in paragraph A37, in relation to whether the acquiree financial information is factually supportable include:

- Inquiring of the acquiree's management about:
 - The process by which the source from which the acquiree financial information has been extracted has been prepared and the reliability of the underlying accounting records to which the source is agreed or reconciled.
 - Whether all transactions have been recorded.
 - Whether the source from which the acquiree financial information has been extracted has been prepared in accordance with the acquiree's accounting policies.
 - Whether there have been any changes in accounting policies from the most recent audited or reviewed period and, if so, how such changes have been dealt with.
 - Its assessment of the risk that the source from which the acquiree financial information has been extracted may be materially misstated as a result of fraud.
 - The effect of changes in the acquiree's business activities and operations.
- If the practitioner has audited or reviewed the immediately preceding annual or interim financial information, considering the findings of such audit or review and whether these might indicate any issues with the preparation of the source from which the acquiree financial information has been extracted.
- Corroborating the information provided by the acquiree's management in response to the practitioner's inquiries when the responses appear inconsistent with the practitioner's understanding of the acquiree or the engagement circumstances.
- Comparing the source from which the acquiree financial information has been extracted with the corresponding prior period financial information and, as applicable, the immediately preceding annual or interim financial information, and discussing significant changes with the acquiree's management.

Modified Audit Opinion or Review Conclusion, or Emphasis of Matter Paragraph, with Respect to the Source from Which the Unadjusted Financial Information Has Been Extracted or the Source from Which the Acquiree or Divestee Financial Information Has Been Extracted

Potential Consequence (Ref: Para. 23(a))

A39. Not all modified audit opinions, review conclusions or Emphasis of Matter paragraphs with respect to either the source from which the unadjusted financial information has been extracted or the source from which the acquiree or divestee financial information has been extracted may necessarily affect whether the

pro forma financial information can be compiled, in all material respects, on the basis of the applicable criteria. For example, a qualified audit opinion may have been expressed on the entity's financial statements because of the non-disclosure of remuneration for those charged with governance as required by the applicable financial reporting framework. If this is the case and these financial statements are used as the source from which the unadjusted financial information has been extracted, such qualification may have no consequence on whether pro forma net asset and income statements can be compiled, in all material respects, on the basis of the applicable criteria.

Further Appropriate Action (Ref: Para. 23(b), 24)

A40. *Further appropriate action that the practitioner may take includes, for example:*

- In relation to the requirement in paragraph 23(b):
 - Discussing the matter with the responsible party.
 - Where possible under relevant law or regulation, making a reference in the practitioner's report to the modified audit opinion, review conclusion, or the Emphasis of Matter paragraph, if, in the practitioner's professional judgment, the matter is of sufficient relevance and importance to users' understanding of the pro forma financial information.
- In relation to the requirement in paragraph 24, where possible under relevant law or regulation, modifying the practitioner's opinion.
- Where possible under relevant law or regulation, withdrawing from the engagement.
- Seeking legal advice.

Evaluating the Presentation of the Pro Forma Financial Information

Avoiding Association with Misleading Financial Information (Ref: Para. 26(b))

A41. *The Code of Ethics issued by the Institute of Chartered Accountants of India requires that a practitioner should not be associated with reports, returns, communications or other information where he believes that the information⁵:*

- (a) Contain a materially false or misleading statement;
- (b) Contain statements or information furnished negligently; or
- (c) Omits or obscures any information required to be included where such omission or obscurity would be misleading.

Disclosures Accompanying the Pro Forma Financial Information (Ref: Para. 14(c), 26(c))

A42. *Appropriate disclosures may include matters such as:*

- The nature and purpose of the pro forma financial information, including the nature of the event or transaction, and the date at which such event is assumed to have occurred or transaction been undertaken;
- The source from which the unadjusted financial information has been extracted, and whether or not an audit or review report on such a source has been published;
- The pro forma adjustments, including a description and explanation of each adjustment. This includes, in the case of acquiree or divestee financial information, the source from which such information has been extracted and whether or not an audit or review report on such a source has been published;

⁵ The Code of Ethics, paragraph 110.2.

I.750 Auditing Pronouncements

- If not publicly available, a description of the applicable criteria on the basis of which the pro forma financial information has been compiled; and
- A statement to the effect that the pro forma financial information has been compiled for illustrative purposes only and that, because of its nature, it does not represent the entity's actual financial position, financial performance, or cash flows.

Relevant law or regulation may require these or other specific disclosures

Consideration of Significant Subsequent Events (Ref: Para. 26(d))

A43. *As the practitioner is not reporting on the source from which the unadjusted financial information has been extracted, there is no requirement for the practitioner to perform procedures to identify events after the date of the source that require adjustment of, or disclosure in, such source. Nevertheless, it is necessary for the practitioner to consider whether any significant events subsequent to the date of the source from which the unadjusted financial information has been extracted have come to the practitioner's attention that may require reference to, or disclosure in, the explanatory notes to the pro forma financial information to avoid the latter being misleading. Such consideration is based on performing the procedures under this SAE or the practitioner's knowledge of the entity and the engagement circumstances. For example, after the date of the source from which the unadjusted financial information has been extracted, the entity may have entered into a capital transaction involving the conversion of its convertible debt into equity, non-disclosure of which could result in the pro forma financial information being misleading.*

Material Inconsistency with Other Information (Ref: Para. 27)

A44. *Further appropriate action that the practitioner may take if the responsible party refuses to revise the pro forma financial information or the other information as appropriate includes, for example:*

- Where possible under relevant law or regulation:
 - Describing the material inconsistency in the practitioner's report.
 - Modifying the practitioner's opinion.
 - withdrawing from the engagement.
- Seeking legal advice.

Written Representations (Ref: Para. 28(a))

A45. *In some circumstances, the types of transactions involved may require the responsible party to select accounting policies for the pro forma adjustments that the entity has not previously had to articulate because it had no relevant transactions. In such a case, the practitioner may request the responsible party to expand the written representations to include confirmation that the selected accounting policies constitute the entity's adopted policies for such types of transactions.*

Forming the Opinion

Assurance on Further Matters Required by the Relevant Law or Regulation (Ref: Para. 29)

A46. *Relevant law or regulation may require the practitioner to express an opinion on matters other than whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria. In some of these circumstances, it may not be necessary for the practitioner to perform additional procedures. For example, the relevant law or regulation may require the practitioner to express an opinion about whether the basis on which the responsible party has compiled the pro forma financial information is consistent with the entity's accounting policies. Compliance with the requirements in paragraphs 18 and 22(c) of this SAE provides a basis for expressing such an opinion.*

A47. *In other circumstances, the practitioner may need to perform additional procedures. The nature and*

extent of such additional procedures will vary with the nature of the other matters on which the relevant law or regulation requires the practitioner to express an opinion.

Statement of the Practitioner's Responsibility for the Report

A48. The relevant law or regulation may require the practitioner to include in the practitioner's report an explicit statement asserting or confirming the practitioner's responsibility for the report. The inclusion of such an additional legal or regulatory statement in the practitioner's report is not incompatible with the requirements of this SAE.

Disclosure of the Applicable Criteria (Ref: Para. 30)

A49. The responsible party need not repeat in the explanatory notes accompanying the pro forma financial information any criteria that are prescribed by the relevant law or regulation, or promulgated by an authorized or recognized standard-setting organization. Such criteria will be publicly available as part of the reporting regime and are therefore implicit in the responsible party's compilation of the pro forma financial information.

A50. Where the responsible party has developed any specific criteria, it is necessary that those criteria be disclosed so that users may obtain a proper understanding of how the pro forma financial information has been compiled by the responsible party.

Preparing the Assurance Report Title (Ref: Para. 35(a))

A51. A title indicating that the report is the report of an independent practitioner, for example, "Independent Practitioner's Assurance Report on the Compilation of Pro Forma Financial Information Included in a Prospectus," affirms that the practitioner has met all of the relevant ethical requirements regarding independence as required by the Framework for Assurance Engagements⁶. This distinguishes the report of the independent practitioner from reports issued by others.

Addressee(s) (Ref: Para. 35(b))

A52. The relevant law or regulation may specify the addressee(s) of the report. Alternatively, the practitioner may agree with the entity who the addressee(s) will be as part of the terms of the engagement.

Introductory Paragraphs (Ref: Para. 35(c))

A53. As the pro forma financial information will be included in a prospectus that contains other information, the practitioner may consider, if the form of presentation allows, including a reference that identifies the section where the pro forma financial information is presented. This helps readers identify the pro forma financial information to which the practitioner's report relates.

Opinion (Ref: Para. 13(c), 35(h))

A54. Whether the phrase "pro forma financial information has been compiled, in all material respects, on the basis of the [applicable criteria]," or the phrase "pro forma financial information has been properly compiled on the basis stated" is used to express the opinion in any particular jurisdiction is determined by the law or regulation governing reporting on pro forma financial information in that jurisdiction, or by generally accepted practice in that jurisdiction.

A55. The relevant law or regulation in some jurisdictions may prescribe the wording of the practitioner's opinion in terms other than those specified above. Where this is the case, it may be necessary for the practitioner to exercise judgment to determine whether performing the procedures set out in this SAE would enable the practitioner to express the opinion in the wording prescribed by law or regulation, or

⁶ The Framework for Assurance Engagements, paragraph 16

I.752 Auditing Pronouncements

whether further procedures would be necessary.

A56. When the practitioner concludes that performing the procedures set out in this SAE would be sufficient to enable the practitioner to express the opinion in the wording prescribed by law or regulation, it may be appropriate to regard that wording as being equivalent to the two alternative wordings of the opinion specified in this SAE.

Illustrative Report (Ref: Para. 35)

A57. A practitioner's report with an unmodified opinion is set out in the Appendix.

Material Modifications vis-à-vis ISAE 3420, "Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus"

Deletions

1 Paragraph 32 of ISAE 3420 deals with circumstances where the relevant law or regulation precludes publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the practitioner concludes that a modified opinion is nevertheless appropriate, the practitioner shall discuss the matter with the responsible party and if the responsible party does not agree to make the necessary changes, the practitioner shall **withhold the report** or withdraw from the engagement or consider seeking legal advice. Since in India, the practice of withholding the report is not in vogue, the option of withholding the report by the practitioner has been deleted. Similarly in paragraph A40 and paragraph A44, the option of withholding the report by the practitioner has been deleted.

Appendix (Ref: Para. A57)

Illustrative Practitioner's Report with an Unmodified Opinion

INDEPENDENT PRACTITIONER'S ASSURANCE REPORT ON THE COMPILATION OF PRO FORMA FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS

[Appropriate Addressee(s)]

Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

We have completed our assurance engagement to report on the compilation of pro forma financial information of ABC Company by [the responsible party]. The pro forma financial information consists of [the pro forma balance sheet as at [date]], [the pro forma statement of profit and loss for the period ended [date]], [the pro forma cash flow statement for the period ended [date]], and related notes [as set out on pages xx-xx of the prospectus issued by the company]. The applicable criteria on the basis of which [the responsible party] has compiled the pro forma financial information are [specified in [Securities Regulation XX] and described in [Note X]]/[described in [Note X]].

The pro forma financial information has been compiled by [the responsible party] to illustrate the impact of the [event or transaction] [set out in Note X] on the [company's financial position as at specify date] [and] [the company's/its financial performance [and cash flows] for the period ended specify date] as if the [event or transaction] had taken place at [specify date] [and specify date respectively]. As part of this process, information about the company's [financial position], [financial performance] [and cash flows] has been extracted by [the responsible party] from the company's financial statements [for the period ended

[date]], on which [[an audit]/[a review] report]/[no audit or review report] has been published.⁷

[The Responsible Party's] Responsibility for the Pro Forma Financial Information

[The responsible party] is responsible for compiling the pro forma financial information on the basis of the [applicable criteria]. This responsibility includes the responsibility for designing, implementing and maintaining internal control relevant for compiling the pro forma financial information on the basis of the [applicable criteria] that is free from material misstatement, whether due to fraud or error. The {Responsible party} is also responsible for identifying and ensuring that the Company complies with the laws and regulations applicable to its activities, including compliance with the provisions of the laws and regulations for the compilation of Pro Forma Financial Information.

Practitioner's Responsibilities

Our responsibility is to express an opinion , as required by[Reference to the relevant law or regulation], about whether the pro forma financial information has been compiled, in all material respects, by [the responsible party] on the basis of the[applicable criteria].

We conducted our engagement in accordance with Standard on Assurance Engagements (SAE) 3420, Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus, issued by the Institute of Chartered Accountants of India. This Standard requires that the practitioner comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether [the responsible party] has compiled, in all material respects, the pro forma financial information on the basis of the[applicable criteria].

For purposes of this engagement, we are not responsible for updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor have we, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information.

The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. Accordingly, we do not provide any assurance that the actual outcome of the event or transaction at[specify date] would have been as presented.

A reasonable assurance engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used by [the responsible party] in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether:

- The related pro forma adjustments give appropriate effect to those criteria; and
- The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information.

The procedures selected depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the company, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances.

The engagement also involves evaluating the overall presentation of the pro forma financial information.

⁷ Where the audit or review report has been modified, reference may be made to where the modification has been described in the prospectus

I.754 Auditing Pronouncements

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion, [the pro forma financial information has been compiled, in all material respects, on the basis of the [applicable criteria]]/[the pro forma financial information has been properly compiled on the basis stated].

Report on Other Legal or Regulatory Requirements

[Relevant law or regulation may require the practitioner to express an opinion on other matters (see paragraphs A46–A47). The form and content of this section of the practitioner's report will vary with the nature of such other reporting responsibilities.]

*For XYZ and
Co. Chartered
Accountants Firm
Registration number
Signature
(Name of the Member Signing the Report)
(Designation⁸)
Membership Number*

Place of Signature

Date

⁸ Partner or Proprietor, as the case may be.

SRS 4400
Engagements to Perform
Agreed-upon Procedures
regarding Financial Information
(Effective for all agreed upon
procedures engagements on or after April 1, 2004)

Introduction

1. The purpose of this Standard on Related Services (SRS) is to establish standards and provide guidance on the auditor's¹ professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.

2. In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement. For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

3. This SRS is directed towards engagements regarding financial information. However, it may provide useful guidance for engagements to perform agreed-upon procedures regarding non-financial information; provided the auditor has adequate knowledge of the subject matter in question and reasonable criteria exist on which to base his findings. These Standards on Auditing is to be read in conjunction with the "Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services"². The principles laid down in the other SAs, issued by the Institute of Chartered Accountants of India, may be used by the auditor, to the extent practicable, in applying this SRS.

Objective of an Agreed-upon Procedures Engagement

4. **The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.**

5. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed by him in his report. Instead, users of the report assess for themselves the procedures and the findings reported by the auditor and draw their own conclusions from the work done by the auditor.

¹ The term "auditor" is used throughout this SRS when describing services involving performance of agreed-upon procedures. Such reference is not intended to imply that a person performing related services need necessarily be the auditor of the entity's financial statements.

² The Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", which is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.

I.756 Auditing Pronouncements

6. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. However, it is possible in certain circumstances that the report of the engagement may not be restricted only to those parties that have agreed to the procedures to be performed, but made available to a wider range of entities or individuals, e.g., in case of government organisations.

General Principles of an Agreed-upon Procedures Engagement

7. **The auditor should comply with the Code of Ethics, issued by the Institute of Chartered Accountants of India.** Ethical principles governing the auditor's professional responsibilities for this type of engagement are:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality;
- (e) Professional conduct; and
- (f) Technical standards

Independence is not a requirement for agreed-upon procedures engagement, however, the terms or objective of the engagement may require the auditor to comply with the independence requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India. **Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.**

8. **The auditor should conduct an agreed-upon procedure engagement in accordance with this SRS and the terms of the engagement.**

Defining the Terms of the Engagement

9. **The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.** Matters to be agreed include the following:

- (a) Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.
- (b) Stated purpose for the engagement.
- (c) Identification of the financial information to which the agreed-upon procedures will be applied.
- (d) Nature, timing and extent of the specific procedures to be applied.
- (e) Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

10. In certain circumstances, for example, when the procedures have been agreed to between the regulator, industry representatives and representatives of the accounting profession, the auditor may not be able to discuss the procedures with all the parties who will receive the report. In such cases, the auditor may consider, for example, discussing the procedures to be applied with appropriate representatives of the parties involved, reviewing relevant correspondence from such parties.

11. It is in the interests of both the client and the auditor that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of

the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.

12. Matters that would be included in the engagement letter include:
- ◆ A listing of the procedures to be performed as agreed-upon between the parties.
 - ◆ A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

An example of an engagement letter appears in **Appendix I** to this SRS.

Planning

13. **The auditor should plan the work so that an effective engagement will be performed.**

Documentation

14. **The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this SRS and the terms of the engagement.**

Procedures and Evidence

15. **The auditor should carry out the procedures agreed-upon and use the evidence obtained as the basis for the report of factual findings.**

16. The procedures applied in an engagement to perform agreed-upon procedures may include:

- ◆ Inquiry and analysis.
- ◆ Recomputation, comparison and other clerical accuracy checks.
- ◆ Observation.
- ◆ Inspection.
- ◆ Obtaining confirmations.

Appendix II to this SRS is an example report which contains an illustrative list of procedures which may be used as one part of a typical agreed-upon procedures engagement.

Reporting

17. **The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.**

18. **The report of factual findings should contain:**

- (a) **Title;**
- (b) **Addressee (ordinarily, the appointing authority);**
- (c) **Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;**
- (d) **A statement that the procedures performed were those agreed-upon with the recipient;**
- (e) **A statement that the engagement was performed in accordance with the Standard on Related Services applicable to agreed-upon procedures engagements;**
- (f) **Identification of the purpose for which the agreed-upon procedures were performed;**

I.758 Auditing Pronouncements

- (g) A listing of the specific procedures performed;
- (h) A description of the auditor's factual findings including sufficient details of errors and exceptions found;
- (i) A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
- (j) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
- (k) A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
- (l) A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;
- (m) Date of the report;
- (n) Place of signature ; and
- (o) Auditor's signature

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

Appendix II to this SRS contains an example of a report of factual findings issued in connection with an engagement to perform agreed-upon procedures regarding financial information.

Effective Date

19. This Standard on Related Services is applicable to all agreed upon procedures engagements beginning on or after April 1, 2004.

Compatibility with the International Standard on Auditing (ISA) 920**

The standards established in this Standard on Related Services are generally consistent in all material respects with those set out in the International Standard on Auditing (ISA) 920, "Engagements to Perform Agreed-upon Procedures regarding Financial Information".

** Now the International Standard on Related Services (ISRS) 4400.

Appendix I

Example of an Engagement Letter for an Agreed-upon Procedures Engagement

The following letter is for use as a guide in conjunction with paragraph 12 of this Standard on Related Services and is not intended to be a standard letter. The engagement letter will need to be varied according to individual requirements and circumstances.

Date

To the Board of Directors (or other appropriate representatives of the client who engaged the auditor).

This is in reference to your letter dated _____, appointing us to perform agreed-upon procedures in respect of _____ (*identify the items, e.g., sales, profit of a segment, accounts receivables, etc., of the entity*).

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services that we will provide.

Our engagement will be conducted in accordance with the Standard on Related Services (SRS) 4400, "Engagements to Perform Agreed-upon Procedures regarding Financial Information", issued by the Institute of Chartered Accountants of India and we will indicate so in our report.

We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

(Describe the nature, timing and extent of the procedures to be performed, including specific reference, where applicable, to the identity of documents and records to be read, individuals to be contacted and parties from whom confirmations will be obtained.)

The procedures that we will perform are solely to assist you in _____ (*state purpose*). Our report is not to be used for any other purpose and is solely for your information, and/ or for use by _____ (*in case the terms of reference so require*).

The procedures that we will perform will not constitute an audit or a review made in accordance with the generally accepted auditing standards in India and, consequently, no assurance will be expressed.

We look forward to your full cooperation and trust that you will make available to us whatever records, documentation and other information requested in connection with our engagement.

Our fees will be billed as work progresses.

I.760 Auditing Pronouncements

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the terms of the engagement including the specific procedures, which we have agreed will be performed.

For XYZ & Co
Chartered Accountants

.....

Signature
(Name of the Member)
Designation³

Date:
Address:

Acknowledged on behalf of ABC Company by
(signed)

.....
Name and Title
Date
Address

Appendix II

Example of a Report of Factual Findings in Connection with Accounts Receivable

CONFIDENTIAL

Report Of Factual Findings In Connection With Agreed-upon Procedures Assignment Related To Accounts Receivable

To *(those who engaged the auditor)*

We have performed the procedures agreed with you and enumerated below with respect to the accounts receivable of ABC Company as at _____(date), set forth in the accompanying schedules *(not shown in this example)*. Our engagement was undertaken in accordance with the Standard on Related Services (SRS) 4400, "Engagements to Perform Agreed-upon Procedures regarding Financial Information", issued by the Institute of Chartered Accountants of India. The procedures were performed solely to assist you in evaluating the validity of the accounts receivable and are summarized as follows:

1. We obtained and checked the addition of the trial balance of accounts receivable as at _____(date), prepared by ABC Company, and we compared the total to the balance in the related general ledger account.
2. We compared the attached list *(not shown in this example)* of major customers and the amounts outstanding at _____(date) to the related names and amounts in the trial balance.

³ Partner or proprietor, as the case may be.

3. We obtained customers' statements or confirmations from customers to confirm balances outstanding at _____ (date).

4. We compared such statements or confirmations to the amounts referred to in 2 above. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, debit notes and outstanding cheques, each of which was greater than Rs. XXX. We located and examined such invoices and debit notes subsequently raised and cheques subsequently received and we ascertained that they have been rightly listed as outstanding on the reconciliations.

We report our findings below:

- (a) With respect to item 1, we found the addition to be correct and the total amount to be in agreement.
- (b) With respect to item 2, we found the amounts compared to be in agreement.
- (c) With respect to item 3, we found there were suppliers' statements for all such customers.
- (d) With respect to item 4, we found the amounts agreed, or with respect to amounts which did not agree, we found the Company had prepared reconciliations and that the debit notes, invoices and outstanding cheques over Rs. XXX were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with the generally accepted auditing standards in India, we do not express any assurance on the accounts receivable as at _____(date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with the generally accepted auditing standards in India, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

Date:

Place:

For XYZ & Co
Chartered Accountants

.....

Signature

(Name of the Member and Membership number)

Designation⁴

⁴ Partner or proprietor as the case may be.

SRS 4410(Revised)

Compilation Engagements

*(Effective for compilation engagements undertaken after
March 31, 2016.)*

Introduction

Scope of this SRS

1. This Standard on Related Services (SRS) deals with the practitioner's responsibilities when engaged to assist management with the preparation and presentation of historical financial information without obtaining any assurance on that information, and to report on the engagement in accordance with this SRS. (Ref: Para. A1–A2)

2. This SRS applies to compilation engagements for historical financial information. The SRS may be applied, adapted as necessary, to compilation engagements for financial information other than historical financial information, and to compilation engagements for non-financial information. Hereinafter in this SRS, reference to "financial information" means "historical financial information." (Ref: Para. A3–A4)

3. When the practitioner is requested to assist management with the preparation and presentation of financial information, appropriate consideration may need to be given to whether the engagement should be undertaken in accordance with this SRS. Factors that indicate that it may be appropriate to apply this SRS, including reporting under this SRS, include whether:

- The financial information is required under provisions of applicable law or regulation, and whether it is required to be publicly filed.
- External parties other than the intended users of the compiled financial information are likely to associate the practitioner with the financial information, and there is a risk that the level of the practitioner's involvement with the information may be misunderstood, for example:
 - If the financial information is intended for use by parties other than management or those charged with governance, or may be provided to, or obtained by, parties who are not the intended users of the information; and
 - If the practitioner's name is identified with the financial information. (Ref: Para. A5)

Relationship with SQC 1¹

4. Quality control systems, policies and procedures are the responsibility of the firm. SQC 1 applies to firms of professional accountants in respect of a firm's compilation engagements.² The provisions of this SRS regarding quality control at the level of individual compilation engagements are premised on the basis that the firm is subject to SQC 1. (Ref: Para. A6–A10)

¹ Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

² SQC 1, paragraph 1.

The Compilation Engagement

5. Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity. The value of a compilation engagement performed in accordance with this SRS to users of financial information results from the application of the practitioner's professional expertise in accounting and financial reporting and compliance with professional standards, including relevant ethical requirements, and the clear communication of the nature and extent of the practitioner's involvement with the compiled financial information. (Ref: Para. A11–A14)
6. Since a compilation engagement is not an assurance engagement, a compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of the financial information.
7. Management retains responsibility for the financial information and the basis on which it is prepared and presented. That responsibility includes application by management of the judgment required for the preparation and presentation of the financial information, including the selection and application of appropriate accounting policies and, where needed, developing reasonable accounting estimates. (Ref: Para. A11–A12)
8. This SRS does not impose responsibilities on management or those charged with governance, or override laws and regulations that govern their responsibilities. An engagement performed in accordance with this SRS is conducted on the premise that management, or those charged with governance where appropriate, have agreed certain responsibilities that are fundamental to the performance of the compilation engagement. (Ref: Para. A11–A12)
9. Financial information that is the subject of a compilation engagement may be required for various purposes including:
- (a) To comply with mandatory periodic financial reporting requirements established in law or regulation, if any; or
 - (b) For purposes unrelated to mandatory financial reporting under relevant law or regulation, including for example:
 - For management or those charged with governance, prepared on a basis appropriate for their particular purposes (such as preparation of financial information for internal use).
 - For periodic financial reporting undertaken for external parties under a contract or other form of agreement (such as financial information provided to a funding body to support provision or continuation of a grant).
 - For transactional purposes, for example to support a transaction involving changes to the entity's ownership or financing structure (such as for a merger or acquisition).
10. Different financial reporting frameworks can be used to prepare and present financial information, ranging from a simple entity-specific basis of accounting to established financial reporting standards. The financial reporting framework adopted by management to prepare and present the financial information will depend on the nature of the entity and the intended use of the information. (Ref: Para. A15–A17)

Authority of this SRS

11. This SRS contains the objectives of the practitioner in following the SRS which provide the context in

I.764 Auditing Pronouncements

which the requirements of this SRS are set, and are intended to assist the practitioner in understanding what needs to be accomplished in a compilation engagement.

12. This SRS contains requirements, expressed using “shall,” that are designed to enable the practitioner to meet the stated objectives.

13. In addition, this SRS contains introductory material, definitions, and application and other explanatory material, that provide context relevant to a proper understanding of the SRS.

14. The application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in this SRS that assists in the application of the requirements.

Effective Date

15. This SRS is effective for compilation engagements undertaken after March 31, 2016.

Objectives

16. The practitioner’s objectives in a compilation engagement under this SRS are to:

- (a) Apply accounting and financial reporting expertise to assist management in the preparation and presentation of financial information in accordance with an applicable financial reporting framework based on information provided by management; and
- (b) Report in accordance with the requirements of this SRS.

Definitions

17. The Glossary of Terms (the Glossary) includes the terms defined in this SRS and also includes descriptions of other terms found in this SRS, to assist in consistent interpretation. The following terms have the meanings attributed below for the purposes of this SRS:

- (a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial information that is acceptable in view of the nature of the entity and the objective of the financial information, or that is required by law or regulation. (Ref: Para. A29–A31)
- (b) Compilation engagement – An engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by this SRS. Throughout this SRS, the words “compile”, “compiling” and “compiled” are used in this context.
- (c) Engagement partner – The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (d) Engagement team – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes external experts engaged by the firm or a network firm.
- (e) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported item in the financial information, and the amount, classification, presentation, or disclosure

that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the financial information is prepared in accordance with a fair presentation framework, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the practitioner's judgment, are necessary for the financial information to be presented fairly, in all material respects, or to give a true and fair view.

- (f) Practitioner – A professional accountant in public practice³ who conducts the compilation engagement. The term includes the engagement partner or other members of the engagement team, or, as applicable, the firm. Where this SRS expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “practitioner” is used.
- (g) Relevant ethical requirements – Ethical requirements the engagement team is subject to when undertaking compilation engagements. These requirements comprise the Code of Ethics issued by ICAI together with other relevant pronouncements issued by ICAI. (Ref: Para. A20)

Requirements

Conduct of a Compilation Engagement in Accordance with this SRS

18. The practitioner shall have an understanding of the entire text of this SRS, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

Complying with Relevant Requirements

19. The practitioner shall comply with each requirement of this SRS unless a particular requirement is not relevant to the compilation engagement, for example if the circumstances addressed by the requirement do not exist in the engagement.

20. The practitioner shall not represent compliance with this SRS unless the practitioner has complied with all requirements of this SRS relevant to the compilation engagement.

Ethical Requirements

21. The practitioner shall comply with relevant ethical requirements. (Ref: Para. A18–A20)

Professional Judgment

22. The practitioner shall exercise professional judgment in conducting a compilation engagement. (Ref: Para. A21–A23)

Engagement Level Quality Control

23. The engagement partner shall take responsibility for:

- (a) The overall quality of each compilation engagement to which that partner is assigned; and
- (b) The engagement being performed in accordance with the firm's quality control policies and procedures, by:
 - (i) Following appropriate procedures regarding the acceptance and continuance of client relationships and engagements; (Ref: Para. A25)

³ Attention is also drawn to footnote 1 to the Framework for Assurance Engagements, which clarifies that a “practitioner” refers to the members of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

I.766 Auditing Pronouncements

- (ii) Being satisfied that the engagement team collectively has the appropriate competence and capabilities to perform the compilation engagement;
- (iii) Being alert for indications of non-compliance by members of the engagement team with relevant ethical requirements, and determining the appropriate action if matters come to the engagement partner's attention indicating that members of the engagement team have not complied with relevant ethical requirements; (Ref: Para. A26)
- (iv) Directing, supervising and performing the engagement in compliance with professional standards and applicable legal and regulatory requirements; and
- (v) Taking responsibility for appropriate engagement documentation being maintained.

Engagement Acceptance and Continuance

Continuance of Client Relationships, Engagement Acceptance and Agreeing the Terms of the Engagement

24. The practitioner shall not accept the engagement unless the practitioner has agreed the terms of engagement with management, and the engaging party if different, including:

- (a) The intended use and distribution of the financial information, and any restrictions on either its use or its distribution where applicable; (Ref: Para. A19, A27–A28, A31–A32)
- (b) Identification of the applicable financial reporting framework; (Ref: Para. A19, A29–A32)
- (c) The objective and scope of the compilation engagement; (Ref: Para. A19)
- (d) The responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements; (Ref: Para. A19)
- (e) The responsibilities of management for: (Ref: Para. A33–A35)
 - (i) The financial information, and for the preparation and presentation thereof, in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial information and the intended users;
 - (ii) Design, implementation and maintenance of such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;
 - (iii) The accuracy and completeness of the records, documents, explanations and other information provided by management for the compilation engagement; and
 - (iv) Judgments needed in the preparation and presentation of the financial information, including those for which the practitioner may provide assistance in the course of the compilation engagement; and (Ref: Para. A21)
- (f) The expected form and content of the practitioner's report.

25. The practitioner shall record the agreed terms of engagement in an engagement letter or other suitable form of written agreement, prior to performing the engagement. (Ref: Para. A36–A38)

Recurring Engagements

26. On recurring compilation engagements, the practitioner shall evaluate whether circumstances, including changes in the engagement acceptance considerations, require the terms of engagement to

be revised and whether there is need to remind management of the existing terms of engagement. (Ref: Para. A39)

Communication with Management and Those Charged with Governance

27. The practitioner shall communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the compilation engagement, all matters concerning the compilation engagement that, in the practitioner's professional judgment, are of sufficient importance to merit the attention of management or those charged with governance, as appropriate. (Ref: Para. A40)

Performing the Engagement

The Practitioner's Understanding

28. The practitioner shall obtain an understanding of the following matters sufficient to be able to perform the compilation engagement: (Ref: Para. A41–A43)

- (a) The entity's business and operations, including the entity's accounting system and accounting records; and
- (b) The applicable financial reporting framework, including its application in the entity's industry.

Compiling the Financial Information

29. The practitioner shall compile the financial information using the records, documents, explanations and other information, including significant judgments, provided by management.

30. The practitioner shall discuss with management, or those charged with governance as appropriate, those significant judgments, for which the practitioner has provided assistance in the course of compiling the financial information. (Ref: Para. A44)

31. Prior to completion of the compilation engagement, the practitioner shall read the compiled financial information in light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework. (Ref: Para. A45)

32. If, in the course of the compilation engagement, the practitioner becomes aware that the records, documents, explanations or other information, including significant judgments, provided by management for the compilation engagement are incomplete, inaccurate or otherwise unsatisfactory, the practitioner shall bring that to the attention of management and request the additional or corrected information.

33. If the practitioner is unable to complete the engagement because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing. (Ref: Para. A51)

34. If the practitioner becomes aware during the course of the engagement that:

- (a) The compiled financial information does not adequately refer to or describe the applicable financial reporting framework; (Ref: Para. A46)
- (b) Amendments to the compiled financial information are required for the financial information not to be materially misstated; or (Ref: Para. A47–A49)
- (c) The compiled financial information is otherwise misleading, (Ref: Para. A50)

I.768 Auditing Pronouncements

the practitioner shall propose the appropriate amendments to management.

35. If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing. (Ref: Para. A51)

36. If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances. (Ref: Para A52)

37. The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information. (Ref: Para. A62)

Documentation

38. The practitioner shall include in the engagement documentation: (Ref: Para. A53–A55)

- (a) Significant matters arising during the compilation engagement and how those matters were addressed by the practitioner;
- (b) A record of how the compiled financial information reconciles with the underlying records, documents, explanations and other information, provided by management; and
- (c) A copy of the final version of the compiled financial information for which management or those charged with governance, as appropriate, has acknowledged their responsibility, and the practitioner's report. (Ref: Para. A62)

The Practitioner's Report

39. An important purpose of the practitioner's report is to clearly communicate the nature of the compilation engagement, and the practitioner's role and responsibilities in the engagement. The practitioner's report is not a vehicle to express an opinion or conclusion on the financial information in any form.

40. The practitioner's report issued for the compilation engagement shall be in writing, and shall include the following elements: (Ref: Para. A56–A57, A63)

- (a) The report title;
- (b) The addressee(s), as required by the terms of the engagement; (Ref: Para. A58)
- (c) A statement that the practitioner has compiled the financial information based on information provided by management;
- (d) A description of the responsibilities of management, or those charged with governance as appropriate, in relation to the compilation engagement, and in relation to the financial information;
- (e) Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information;
- (f) Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates;
- (g) A description of the practitioner's responsibilities in compiling the financial information, including that

- the engagement was performed in accordance with this SRS, and that the practitioner has complied with relevant ethical requirements;
- (h) A description of what a compilation engagement entails in accordance with this SRS;
 - (i) Explanations that:
 - (i) Since a compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation; and
 - (ii) Accordingly, the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework.
 - (j) If the financial information is prepared using a special purpose financial reporting framework, an explanatory paragraph that: (Ref: Para. A59–A61)
 - (i) Describes the purpose for which the financial information is prepared and, if necessary, the intended users, or contains a reference to a note in the financial information that discloses this information; and
 - (ii) Draws the attention of readers of the report to the fact that the financial information is prepared in accordance with a special purpose framework and that, as a result, the information may not be suitable for other purposes;
 - (k) The date of the practitioner's report;
 - (l) The practitioner's signature; and
 - (m) The Place of signature.
41. The practitioner shall date the report on the date the practitioner has completed the compilation engagement in accordance with this SRS. (Ref: Para. A62)

Application and Other Explanatory Material

Scope of this SRS

General Considerations (Ref: Para. 1)

A1. In a compilation engagement where the engaging party is someone other than management or those charged with governance of the entity, this SRS may be applied adapted as necessary.

A2. A practitioner's involvement with services or activities in the course of assisting management of an entity with the preparation and presentation of the entity's financial information can take many different forms. When the practitioner is engaged to provide such services or activities for an entity under this SRS, the practitioner's association with the financial information is communicated through the practitioner's report provided for the engagement in the form required by this SRS. The practitioner's report contains the practitioner's explicit assertion of compliance with this SRS.

Application to Compilation Engagements Other than for Historical Financial Information (Ref: Para. 2)

A3. This SRS addresses engagements where the practitioner assists management in the preparation and presentation of historical financial information. The SRS may, however, also be applied, adapted as

I.770 Auditing Pronouncements

necessary, when the practitioner is engaged to assist management in preparing and presenting other financial information. Examples include:

- Pro forma financial information.
- Prospective financial information, including financial budgets or forecasts.

A4. Practitioners may also undertake engagements to assist management in the preparation and presentation of non-financial information, for example, greenhouse gas statements, corporate social responsibility reporting, environmental reporting, sustainability reporting, integrated reporting, statistical returns or other information returns. In those circumstances, the practitioner may apply this SRS, adapted as necessary, as relevant to those types of engagements.

Considerations Relevant to Application of the SRS (Ref: Para. 3)

A5. Mandatory application of this SRS may be specified in national settings for engagements where practitioners undertake services relevant to the preparation and presentation of financial information of an entity (such as in relation to preparation of historical financial statements required for public filing). If mandatory application is not specified, either under law or regulation, or under applicable professional standards or otherwise, the practitioner may nevertheless conclude that applying this SRS is appropriate in the circumstances.

Relationship with SQC 1 (Ref: Para. 4)

A6. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for related services engagements, including compilation engagements. Those responsibilities are directed at establishing:

- The firm's quality control system; and
- The firm's related policies designed to achieve the objective of the quality control system and its procedures to implement and monitor compliance with those policies.

A7. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- (b) Reports issued by the firm or engagement partners are appropriate in the circumstances.⁴

A8. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures applicable to the engagement.

A9. Unless information provided by the firm or other parties suggests otherwise, the engagement team is entitled to rely on the firm's system of quality control. For example, the engagement team may rely on the firm's system of quality control in relation to:

- Competence of personnel through their recruitment and formal training.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to legal and regulatory requirements through the monitoring process.

⁴ SQC 1, paragraph 3.

In considering deficiencies identified in the firm's system of quality control that may affect the compilation engagement, the engagement partner may consider measures taken by the firm to rectify the situation that the engagement partner considers are sufficient in the context of that compilation engagement.

A10. A deficiency in the firm's system of quality control does not necessarily indicate that a compilation engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements, or that the practitioner's report was not appropriate.

The Compilation Engagement

Use of the Terms "Management" and "Those Charged with Governance" (Ref: Para. 5, 7–8)

A11. The respective responsibilities of management and those charged with governance will differ between entities of various types. These differences affect the way the practitioner applies the requirements of this SRS regarding management or those charged with governance. Accordingly, the phrase "management and, where appropriate, those charged with governance" used in various places throughout this SRS is intended to alert the practitioner to the fact that different entity environments may have different management and governance structures and arrangements.

A12. Various responsibilities relating to the preparation of financial information and external financial reporting fall to either management or those charged with governance according to factors such as:

- The resources and structure of the entity.
- The respective roles of management and those charged with governance within the entity as set out in relevant law or regulation or, if the entity is not regulated, in any formal governance or accountability arrangements established for the entity (for example, as recorded in contracts, or a constitution or other type of document by which an entity is established).

In many small entities, there is often no separation of the management and governance roles for the entity, or those charged with governance of the entity may also be involved in managing the entity. In most other cases, especially in larger entities, management is responsible for execution of the business or activities of the entity and reporting thereon, while those charged with governance have oversight of management. In larger entities, those charged with governance will often have or assume responsibility for approving the financial information of the entity, particularly when it is intended for use by external parties. In large entities, often a subgroup of those charged with governance, such as an audit committee, is charged with certain oversight responsibilities.

Involvement in Other Activities Relating to Preparation and Presentation of Financial Information (Ref: Para. 5)

A13. The scope of a compilation engagement will vary depending on the circumstances of the engagement. However, in every case it will involve assisting management in the preparation and presentation of the entity's financial information in accordance with the financial reporting framework, based on information provided by management. In some compilation engagements, management may have already prepared the financial information itself in a draft or preliminary form.

A14. A practitioner may also be engaged to undertake certain other activities on behalf of management, additional to the compilation engagement. For example, the practitioner may be requested to also collect, classify and summarize the underlying accounting data of the entity and process the data in the form of accounting records through to preparation of a trial balance. The trial balance would then be used as the

I.772 Auditing Pronouncements

underlying information from which the practitioner can compile the financial information that is the subject of a compilation engagement undertaken in accordance with this SRS. This is often the case for smaller entities that do not have well-developed accounting systems, or entities that prefer to outsource the preparation of accounting records to external providers. This SRS does not address such additional activities that the practitioner may perform to assist management in other areas, in advance of compiling the entity's financial statements.

Financial Reporting Frameworks (Ref: Para. 10)

A15. The financial information may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (that is, a “general purpose financial reporting framework”); or
- The financial information needs of specific users (that is, a “special purpose financial reporting framework”).
- The requirements of the applicable financial reporting framework determine the form and content of the financial information. The financial reporting framework may, in some cases, be referred to as the “basis of accounting.”

A16. Examples of commonly used general purpose financial reporting frameworks are:

- International Financial Reporting Standards (IFRS) and established national financial reporting standards applicable to publicly-listed entities.
- International Financial Reporting Standards for Small- and Medium-Sized Entities (IFRS for SMEs) and established national financial reporting standards applicable to small- and medium-sized entities.
- Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006.
- Indian Accounting Standards (Ind AS) issued by ICAI.
- Accounting Standards (AS) issued by ICAI.

A17. Examples of special purpose financial reporting frameworks that may be used, depending on the particular purpose of the financial information, are:

- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors;
- The financial reporting provisions established by a regulator to meet the requirements of that regulator; or
- The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant.

Ethical Requirements (Ref: Para. 21)

A18. Chapter 1 of the ICAI's Code of Ethics establishes the fundamental principles of professional ethics that practitioners must comply with, and provides a conceptual framework for applying those principles. The fundamental principles are:

- (a) Integrity;
- (b) Objectivity;

- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

Chapter 2 of the ICAI's Code of Ethics illustrates how the conceptual framework is to be applied in specific situations. In complying with the Code of Ethics, threats to the practitioner's compliance with relevant ethical requirements are required to be identified and appropriately addressed.

Ethical Considerations Regarding the Practitioner's Association with Information (Ref: Para. 21, 24(a)–(d))

A19. Under the Code of Ethics,⁵ in applying the principle of integrity, a professional accountant is required to not be associated with reports, returns, communications or other information where he believes that the information:

- (a) Contains a materially false or misleading statement;
- (b) Contains statements or information furnished negligently; or
- (c) Omits or obscures any information required to be included where such omission or obscurity would be misleading.

Independence (Ref: Para. 17(g), 21)

A20. Notwithstanding that Section 290, Independence–Assurance Engagements of the ICAI's Code of Ethics does not apply to compilation engagements, laws or regulations may specify requirements or disclosure rules pertaining to independence.

Professional Judgment (Ref: Para. 22, 24(e)(iv))

A21. Professional judgment is essential to the proper conduct of a compilation engagement. This is because interpretation of relevant ethical requirements and the requirements of this SRS, and the need for informed decisions throughout the performance of a compilation engagement, require the application of relevant knowledge and experience to the facts and circumstances of the engagement. Professional judgment is necessary, in particular, when the engagement involves assisting management of the entity regarding decisions about:

- The acceptability of the financial reporting framework that is to be used to prepare and present the financial information of the entity, in view of the intended use of the financial information and the intended users thereof.
- The application of the applicable financial reporting framework, including:
 - Selection of appropriate accounting policies under that framework;
 - Development of accounting estimates needed for the financial information to be prepared and presented under that framework; and
 - Preparation and presentation of financial information in accordance with the applicable financial reporting framework.

The practitioner's assistance to management is always provided on the basis that management or

⁵ Code of Ethics, paragraph 110.2.

I.774 Auditing Pronouncements

those charged with governance, as appropriate, understand the significant judgments that are reflected in the financial information, and accept responsibility for those judgments.

A22. Professional judgment involves the application of relevant training, knowledge and experience, within the context provided by this SRS and accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the compilation engagement.

A23. The exercise of professional judgment in individual engagements is based on the facts and circumstances that are known to the practitioner up to the date of the practitioner's report on the engagement, including:

- Knowledge acquired from performance of other engagements undertaken for the entity, where applicable (for example, taxation services).
- The practitioner's understanding of the entity's business and operations, including its accounting system, and of the application of the applicable financial reporting framework in the industry in which the entity operates.
- The extent to which the preparation and presentation of the financial information requires the exercise of management judgment.

Engagement Level Quality Control (Ref: Para. 23(b))

A24. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each engagement, emphasize the importance to achieving the quality of the engagement of:

- (a) Performing work that complies with professional standards and regulatory and legal requirements;
- (b) Complying with the firm's quality control policies and procedures as applicable; and
- (c) Issuing the practitioner's report for the engagement in accordance with this SRS.

Acceptance and Continuance of Client Relationships and Compilation Engagements (Ref: Para. 23(b)(i))

A25. SQC 1 requires the firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Information that assists the engagement partner in determining whether acceptance or continuance of client relationships and compilation engagements is appropriate may include information concerning the integrity of the principal owners, key management and those charged with governance. If the engagement partner has cause to doubt management's integrity to a degree that is likely to affect proper performance of the engagement, it may not be appropriate to accept the engagement.

Compliance with Relevant Ethical Requirements in Conducting the Engagement (Ref: Para. 23(b)(iii))

A26. SQC 1 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. This SRS sets out the engagement partner's responsibilities with respect to the engagement team's compliance with relevant ethical requirements.

Engagement Acceptance and Continuance

Identifying the Intended Use of the Financial Information (Ref: Para. 24(a))

A27. The intended use of the financial information is identified with reference to applicable law, regulation, or other arrangements established concerning the provision of financial information of the entity, bearing in mind the financial information needs of parties internal or external to the entity who are the intended users. Examples are financial information required to be provided by an entity in connection with undertaking transactions or financing applications with external parties such as suppliers, banks or other providers of finance or funding.

A28. The practitioner's identification of the intended use of the financial information also involves understanding such factors as the particular purpose(s) of management, or those charged with governance, where applicable, that are intended to be served through requesting the compilation engagement, and those of the engaging party where different. For example, a grant funding body may require the entity to provide financial information compiled by a professional accountant to obtain information about certain aspects of an entity's operations or activities, prepared in a specified form, to support provision of a grant or continuation of an existing grant.

Identification of the Applicable Financial Reporting Framework (Ref: Para. 17(a), 24(b))

A29. The decision about the financial reporting framework that management adopts for the financial information is made in the context of the intended use of the information as described in the agreed terms of engagement, and the requirements of any applicable law or regulation.

A30. The following are examples of factors that indicate it may be relevant to consider whether the financial reporting framework is acceptable:

- The nature of the entity, and whether it is a regulated form of entity, for example, whether it is a profit-oriented business enterprise, a public sector entity or a not-for-profit organization.
- The intended use of the financial information and the intended users. For example, the financial information could be intended to be used by a wide range of users or, alternatively, could be for use by management or by certain external users in the context of a particular purpose specified as part of agreeing the terms of the compilation engagement.
- Whether the applicable financial reporting framework is prescribed or specified, either in applicable law or regulation, or in a contract or other form of agreement with a third party, or as part of governance or accountability arrangements adopted voluntarily by the entity.
- The nature and form of the financial information that is to be prepared and presented under the applicable financial reporting framework, for example, a complete set of financial statements, a single financial statement, or financial information presented in another format agreed between parties to a contract or other form of agreement.

Relevant Factors When Financial Information is Intended for a Particular Purpose (Ref: Para. 24(a)–(b))

A31. The engaging party generally agrees the nature and form of financial information that is intended for a particular purpose with the intended users, for example as specified under the financial reporting provisions of a contract or a project grant or as needed to support the entity's transactions or activities. The relevant contract may require use of an established financial reporting framework, such as a general purpose financial reporting framework established by an authorized or recognized standard-setting body or by law or regulation. Alternatively, the parties to the contract may agree on the use of a general purpose framework with modifications or adaptations that fit their particular needs. In that case, the applicable financial reporting framework may be described in the financial information and in the practitioner's report as being the financial

I.776 Auditing Pronouncements

reporting provisions of the specified contract rather than with reference to the modified financial reporting framework. In such cases, notwithstanding that the compiled financial information may be made more broadly available, the applicable financial reporting framework is a special purpose framework, and the practitioner is required to comply with the relevant reporting requirements of this SRS.

A32. When the applicable financial reporting framework is a special purpose financial reporting framework, the practitioner is required by this SRS to record any restrictions on either the intended use or distribution of the financial information in the engagement letter, and to state in the practitioner's report that the financial information is prepared using a special purpose financial reporting framework, and as a result may not be suitable for other purposes.

Responsibilities of Management (Ref: Para. (24(e))

A33. Under this SRS, the practitioner is required to obtain the agreement of management, or where applicable those charged with governance, on management's responsibilities in relation to both the financial information and the compilation engagement as a condition precedent to accepting the engagement. In smaller entities, management, or those charged with governance where applicable, may not be well-informed about what those responsibilities are, including those arising in applicable law or regulation. In order to obtain management's agreement on an informed basis, the practitioner may find it necessary to discuss those responsibilities with management in advance of seeking management's agreement on its responsibilities.

A34. If management does not acknowledge its responsibilities in the context of a compilation engagement, the practitioner is not able to undertake the engagement, and it is not appropriate for the practitioner to accept the engagement unless required to do so under applicable law or regulation. In circumstances where the practitioner is nevertheless required to accept the engagement, the practitioner may need to communicate with management about the importance of these matters and the implications for the engagement.

A35. The practitioner is entitled to rely on management to provide all relevant information for the compilation engagement on an accurate, complete and timely basis. The form of the information provided by management for the purpose of the engagement will vary in different engagement circumstances. In broad terms, it will comprise records, documents, explanations and other information relevant to the compilation of the financial information using the applicable financial reporting framework. The information provided may include, for example, information about management assumptions, intentions or plans underlying development of accounting estimates needed to compile the information under the applicable financial reporting framework.

Engagement Letter or Other Form of Written Agreement (Ref: Para. 25)

A36. It is in the interest of both management, and the engaging parties where different, and the practitioner that the practitioner sends an engagement letter to management and, where applicable, to the engaging parties prior to performing the compilation engagement, to help avoid misunderstanding with respect to the compilation engagement. An engagement letter confirms the practitioner's acceptance of the engagement and confirms such matters as:

- The objectives and scope of the engagement, including the understanding of the parties to the engagement that the engagement is not an assurance engagement.
- The intended use and distribution of the financial information, and any restrictions on its use or distribution (where applicable).

- The responsibilities of management in relation to the compilation engagement.
- The extent of the practitioner's responsibilities, including that the practitioner will not express an audit opinion or a review conclusion on the financial information.
- The form and content of the report to be issued by the practitioner for the engagement.

Form and Content of the Engagement Letter

A37. The form and content of the engagement letter may vary for each engagement. In addition to the matters required by this SRS, an engagement letter may make reference to, for example:

- Arrangements concerning the involvement of other practitioners and experts in some aspects of the compilation engagement.
- Arrangements to be made with the predecessor practitioner, if any, in the case of an initial engagement.
- The possibility that management or those charged with governance, as appropriate, may be requested to confirm in writing certain information or explanations conveyed orally to the practitioner during the engagement.
- Ownership of the information used for purposes of the compilation engagement, distinguishing between documents and information of the entity provided for the engagement and the practitioner's engagement documentation, having regard to applicable law and regulation.
- A request for management, and the engaging party if different, to acknowledge receipt of the engagement letter and to agree to the terms of the engagement outlined therein.

Illustrative Engagement Letter

A38. An illustrative engagement letter for a compilation engagement is set out in Appendix 1 to this SRS.

Recurring Engagements (Ref: Para. 26)

A39. The practitioner may decide not to send a new engagement letter or other written agreement each period. However, the following factors may indicate that it is appropriate to revise the terms of the compilation engagement, or to remind management or the engaging party, where applicable, of the existing terms of the engagement:

- Any indication that management or the engaging party, where applicable, misunderstands the objective and scope of the engagement.
- Any revised or special terms of the engagement.
- A recent change of senior management of the entity.
- A significant change in ownership of the entity.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements affecting the entity.
- A change in the applicable financial reporting framework.

Communication with Management and Those Charged with Governance (Ref: Para. 27)

A40. The appropriate timing for communications will vary with the circumstances of the compilation engagement. Relevant circumstances include the significance and nature of the matter and any action

I.778 Auditing Pronouncements

expected to be taken by management or those charged with governance. For example, it may be appropriate to communicate a significant difficulty encountered during the engagement as soon as practicable if management or those charged with governance are able to assist the practitioner to overcome the difficulty.

Performing the Engagement

The Practitioner's Understanding (Ref: Para. 28)

A41. Obtaining an understanding of the entity's business and its operations, including the entity's accounting system and accounting records, is an ongoing process that occurs throughout the compilation engagement. The understanding establishes a frame of reference within which the practitioner exercises professional judgment in compiling the financial information.

A42. The breadth and depth of the understanding the practitioner has or obtains about the entity's business and operations is less than that possessed by management. It is directed at the level that is sufficient for the practitioner to be able to compile the financial information under the terms of the engagement.

A43. Examples of matters the practitioner may consider in obtaining an understanding of the entity's business and operations and the applicable financial reporting framework include:

- The legal and regulatory requirements applicable to the entity.
- The size and complexity of the entity and its operations.
- The complexity of the financial reporting framework.
- The entity's financial reporting obligations or requirements, whether they exist under applicable laws and regulation, under the provisions of a contract or other form of agreement with a third party, or in the context of voluntary financial reporting arrangements.
- The level of development of the entity's management and governance structure regarding management and oversight of the entity's accounting records and financial reporting systems that underpin the preparation of financial information of the entity.
- The level of development and complexity of the entity's financial accounting and reporting systems and related controls.
- The nature of the entity's assets, liabilities, revenues and expenses.

Compiling the Financial Information

Significant Judgments (Ref: Para.30)

A44. In some compilation engagements, the practitioner does not provide assistance to management with significant judgments. In other engagements, the practitioner may provide such assistance, for example, in relation to a required accounting estimate or helping management with its consideration of appropriate accounting policies or estimating the useful life of fixed assets or ascertaining the condition of inventory. Where assistance is provided, discussion is needed so that management and those charged with governance, as appropriate, understand the significant judgments reflected in the financial information, and accept their responsibility for those judgments.

Reading the Financial Information (Ref: Para. 31)

A45. The practitioner's reading of the financial information is intended to assist the practitioner in fulfilling the practitioner's ethical requirements relevant to the compilation engagement. (Also refer Para. A19)

Proposing Amendments to the Financial Information

Reference to or description of the applicable financial reporting framework (Ref: Para. 34(a))

A46. There may be circumstances when the applicable financial reporting framework is an established financial reporting framework with significant departures therefrom. If the description of the applicable financial reporting framework in the compiled financial information makes reference to the established framework with significant departures, the practitioner may need to consider whether the reference to the established framework is misleading in the circumstances of the engagement.

Amendment for material misstatements, and for the information not to be misleading (Ref: Para. 34(b)–(c))

A47. The practitioner's consideration of materiality is made in the context of the applicable financial reporting framework. Some financial reporting frameworks discuss the concept of materiality in the context of the preparation and presentation of financial information. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial information;
- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial information are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

For example, in case of companies, the Schedule III to the Companies Act, 2013 gives the following materiality threshold:

A company shall disclose by way of notes additional information regarding aggregate expenditure and income on any item of income or expenditure which exceeds one percent of the revenue from operations or Rs. 1,00,000 whichever is higher.

A48. If present in the applicable financial reporting framework, such a discussion provides a frame of reference for the practitioner in understanding materiality for the purpose of the compilation engagement. If not present, the above considerations provide the practitioner with a frame of reference.

A49. The practitioner's perception of the needs of users of the financial information affects the practitioner's view of materiality. In this context, it is reasonable for the practitioner to assume that users:

- Have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the financial information with reasonable diligence;
- Understand that financial information is prepared and presented to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial information.

A50. The applicable financial reporting framework may include the premise that the financial information is prepared on the going concern basis. If the practitioner becomes aware that uncertainties exist regarding the entity's ability to continue as a going concern, the practitioner may, as appropriate, suggest a more

I.780 Auditing Pronouncements

appropriate presentation under the applicable financial reporting framework, or appropriate disclosures concerning the entity's ability to continue as a going concern, in order to be in compliance with that framework, and to avoid the financial information being misleading.

Conditions that Require the Practitioner to Withdraw from the Engagement (Ref: Para. 33, 35)

A51. In circumstances addressed by the requirements of this SRS where withdrawal from the engagement is necessary, the responsibility to inform management and those charged with governance of the reasons for withdrawing provides an opportunity to explain the practitioner's ethical obligations.

A52. The professional and legal responsibilities of the practitioner may include, for example:

- Reporting to the appointing authority,
- Reporting to the regulatory authority,
- Seeking legal advice,
- Describing the facts in the compilation report.

Documentation (Ref: Para. 38)

A53. The documentation required by this SRS serves a number of purposes, including the following:

- Providing a record of matters of continuing relevance to future compilation engagements.
- Enabling the engagement team, as applicable, to be accountable for its work, including recording the completion of the engagement.

A54. The practitioner may consider also including in the engagement documentation a copy of the entity's trial balance, summary of significant accounting records or other information that the practitioner used to perform the compilation.

A55. In recording how the compiled financial information reconciles with the underlying records, documents, explanations and other information provided by management for the purpose of the compilation engagement, the practitioner may, for example, keep a schedule showing the reconciliation of the entity's general ledger account balances to the compiled financial information, including any adjusting journal entries or other amendments to the financial information that the practitioner has agreed with management in the course of the engagement.

The Practitioner's Report (Ref: Para. 40)

A56. The written report encompasses reports issued in hard copy format and those issued using an electronic medium.

A57. When the practitioner is aware that the compiled financial information and the practitioner's report will be included in a document that contains other information, such as a financial report, the practitioner may consider, if the form of presentation allows, identifying the page numbers on which the financial information is presented. This helps users to identify the financial information to which the practitioner's report relates.

Addressees of the Report (Ref: Para. 40(b))

A58. Law or regulation may specify to whom the practitioner's report is to be addressed in the particular jurisdiction. The practitioner's report is normally addressed to the party who engaged the practitioner under the terms of the engagement, ordinarily the management of the entity.

Financial Information Prepared Using a Special Purpose Financial Reporting Framework (Ref: Para. 40(j))

A59. Under this SRS, if the financial information is prepared using a special purpose financial reporting framework, the practitioner's report is required to draw the attention of readers of the report to the special purpose financial reporting framework used in the financial information, and to state that the financial information may therefore not be suitable for other purposes. This may be supplemented by an additional clause that restricts either the distribution or use, or both, of the practitioner's report to the intended users only.

A60. Financial information prepared for a particular purpose may be obtained by parties other than the intended users, who may seek to use the information for purposes other than those for which the information was intended. For example, a regulator may require certain entities to provide financial statements prepared using a special purpose financial reporting framework, and those financial statements to be on public record. The fact of the wider availability of those financial statements to parties other than the intended users does not mean the financial statements would then become general purpose financial statements. The practitioner's statements required to be included in the practitioner's report are needed to draw readers' attention to the fact that the financial statements are prepared under a special purpose financial reporting framework, and may not, therefore, be suitable for other purposes.

Restriction on Distribution and Use of the Practitioner's Report

A61. The practitioner may consider it appropriate to indicate that the practitioner's report is intended solely for the specified intended users of the financial information. Depending on the law or regulation of the particular jurisdiction, this may be achieved by restricting either the distribution or use, or both, of the practitioner's report to the intended users only.

Completion of the Compilation Engagement and Dating of the Practitioner's Report (Ref: Para. 37, 38, 41)

A62. The process that exists within the entity for the approval of the financial information by management, or by those charged with governance as appropriate, is a relevant consideration for the practitioner when completing the compilation engagement. Depending on the nature and purpose of the financial information, there may be an established approval process that management or those charged with governance are required to follow, or that is prescribed in applicable law and regulation, for the preparation and finalization of financial information or financial statements of the entity.

Illustrative Reports (Ref: Para. 40)

A63. Appendix 2 to this SRS contains illustrations of practitioners' compilation reports incorporating the required elements of the report.

Material Modifications vis-a-vis ISRS 4410 (Revised), "Compilation Engagements"

There are no material modifications in SRS 4410 (Revised) vis-a-vis ISRS 4410 (Revised), 'Compilation Engagements' except addition of the following bullet point in paragraph 24(e):

- Design, implementation and maintenance of such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Illustrative Engagement Letter for a Compilation Engagement

The following is an example of an engagement letter for a compilation engagement that illustrates the relevant requirements and guidance contained in this SRS. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SRS. It will need to be adapted according to the requirements and circumstances of individual compilation engagements. It is drafted to refer to the compilation of financial statements for a single reporting period and would require adaptation if intended or expected to apply to a recurring engagement as described in this SRS. It may be appropriate to seek legal advice that any proposed letter is suitable.

This engagement letter illustrates the following circumstances:

- The financial statements are to be compiled for sole use by the management of a company (ABC Company), and use of the financial statements will be restricted to management. Use and distribution of the practitioner's report is also restricted to management.
- The compiled financial statements will comprise only the balance sheet of the company as at March 31, 20XX and the Statement of Profit and Loss for the year then ended, without notes. Management has determined that the financial statements be prepared on an accrual basis as described.

To the Management⁶ of ABC Company:

[The objective and scope of the compilation engagement]

You have requested that we provide the following services:

On the basis of information that you will provide, we will assist you in the preparation and presentation of the following financial statements for ABC Company: the balance sheet of ABC Company as at March 31, 20XX and the Statement of Profit and Loss for the year then ended. These financial statements will not include explanatory notes, other than a note describing the basis of accounting as set out in this engagement letter.

The purpose for which the financial statements will be used is to provide full-year financial information showing the entity's financial position at the financial reporting date of March 31, 20XX and financial performance for the year then ended. The financial statements will be solely for your use, and will not be distributed to other parties.

Our Responsibilities

A compilation engagement involves applying expertise in accounting and financial reporting to assist you in the preparation and presentation of financial information. Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provide to us for the compilation engagement, or otherwise to gather evidence to express an audit opinion or a review conclusion. Accordingly, we will not express an audit opinion or a review conclusion on whether the financial statements are prepared in accordance with the basis of accounting you have specified, as described above.

⁶ Throughout this illustrative engagement letter, references to "you," "we," "us," "management," "those charged with governance" and "practitioner" would be used or amended as appropriate in the circumstances.

We will perform the compilation engagement in accordance with the Standard on Related Services (SRS) 4410 (Revised), *Compilation Engagements*. SRS 4410 (Revised) requires that, in undertaking this engagement, we comply with relevant ethical requirements. For that purpose, we are required to comply with the ICAI's Code of Ethics

Your Responsibilities

The compilation engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to assist you in the preparation and presentation of the financial statements in accordance with the financial reporting framework you have adopted for the financial statements. Accordingly, you have the following overall responsibilities that are fundamental to our undertaking the compilation engagement in accordance with SRS 4410 (Revised):

- (a) Responsibility for the financial statements and the preparation and presentation thereof in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial statements and the intended users.
- (b) Responsibility for the design, implementation and maintenance of such internal control as you determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- (c) Responsibility for the accuracy and completeness of the records, documents, explanations and other information you provide to us for the purpose of compiling the financial statements.
- (d) Responsibility for the judgments needed in the preparation and presentation of the financial statements, including those for which we may provide assistance in the course of the compilation engagement.

Our Compilation Report

As part of our engagement, we will issue our report attached to the financial statements compiled by us, which will describe the financial statements, and the work we performed for this compilation engagement [see attached]. The report will also note that the use of the financial statements is restricted to the purpose set out in this engagement letter, and that use and distribution of our report provided for the compilation engagement is restricted to you, as the management of ABC Company.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to compile the financial statements described herein, and our respective responsibilities.

[Other relevant information]

[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]

XYZ & Co.

Acknowledged and agreed on behalf of the management of ABC Company by

(signed)

.....

Name and Title

Date

Illustrative Practitioners' Compilation Reports

Compilation Engagement for General Purpose Financial Statements

- Illustration 1: Practitioner's report for an engagement to compile financial statements using a general purpose financial reporting framework.

Compilation Engagement for Financial Statements Prepared for a Special Purpose

- Illustration 2: Practitioner's report for an engagement to compile financial statements using a modified general purpose financial reporting framework.

Compilation Engagements for Financial Information Prepared for a Special Purpose where Use or Distribution of the Financial Information is Restricted to the Intended Users

- Illustration 3: Practitioner's report for an engagement to compile financial statements using the basis of accounting specified in a contract.
- Illustration 4: Practitioner's report for an engagement to compile financial statements using a basis of accounting selected by the management of an entity for financial information required for management's own purposes.
- Illustration 5: Practitioner's report for an engagement to compile financial information that is an element, account or item, being *[insert appropriate reference to information required for a regulatory compliance purpose]*.

Illustration 1: Practitioner's report for an engagement to compile financial statements using a general purpose financial reporting framework.

- General purpose financial statements required under applicable law that specifies that the entity's financial statements are to be prepared applying accounting principles generally accepted in India.

ACCOUNTANT'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the Balance Sheet of ABC Company as at March 31, 20XX, the statement of Profit and Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

We performed this compilation engagement in accordance with Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements in accordance with accounting principles generally accepted in India. We have complied with relevant ethical requirements.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we

do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with accounting principles generally accepted in India.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Compilation Report)
(Designation⁷)
Membership Number

Illustration 2: Practitioner's report for an engagement to compile financial statements using a modified general purpose financial reporting framework.

- Financial statements prepared using a general purpose financial reporting framework adopted by management on a modified basis.
- The applicable financial reporting framework is accounting principles generally accepted in India excluding the treatment of current investments, which have been valued at fair value rather than being carried at the lower of cost and fair value.
- Use or distribution of the financial statements is not restricted.

ACCOUNTANT'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the Balance Sheet of ABC Company as at March 31, 20XX, the statement of Profit and Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

We performed this compilation engagement in accordance with Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements on the basis of accounting described in Note X to the financial statements. We have complied with relevant ethical requirements.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with the basis of accounting described in Note X.

As stated in Note X, the financial statements are prepared and presented in accordance with accounting principles generally accepted in India excluding current investments which have been valued at fair value

⁷ Partner or Proprietor, as the case may be.

I.786 Auditing Pronouncements

rather than being carried at the lower of cost and fair value. The financial statements are prepared for the purpose described in Note Y to the financial statements. Accordingly, these financial statements may not be suitable for other purposes.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Compilation Report)
(Designation⁸)
Membership Number

Illustration 3: Practitioner's report for an engagement to compile financial statements using the basis of accounting specified in a contract.

- Financial statements prepared to comply with the provisions of a contract, applying the basis of accounting specified in the contract.
- The practitioner is engaged by a party other than management or those charged with governance of the entity.
- The financial statements are intended for use only by the parties specified in the contract.
- Distribution and use of the practitioner's report is restricted to the intended users of the financial statements specified in the contract.

ACCOUNTANT'S COMPILATION REPORT

[To the Engaging Party⁹]

We have compiled the accompanying financial statements of ABC Company ("the Company") based on information provided by the management of the Company ("management"). These financial statements comprise *[name all the elements of the financial statements prepared under the basis of accounting specified in the Contract and the period/date to which they relate]*.

We performed this compilation engagement in accordance with Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist management in the preparation and presentation of these financial statements on the basis of accounting described in Note X to the financial statements. We have complied with relevant ethical requirements.

These financial statements and the accuracy and completeness of the information used to compile them are management's responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy

⁸ Partner or Proprietor, as the case may be.

⁹ Alternatively, the appropriate addressee specified in the relevant contract.

or completeness of the information provided to us by management to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with the basis of accounting described in Note X.

As stated in Note X, the financial statements are prepared and presented on the basis described in Clause Z of the provisions of the Company's contract with XYZ Limited dated [insert date of the relevant contract/agreement] ("the Contract"), and for the purpose described in Note Y to the financial statements. Accordingly, these financial statements are intended for use only by the parties specified in the Contract, and may not be suitable for other purposes.

Our compilation report is intended solely for the parties specified in the Contract, and should not be distributed to other parties.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Compilation Report)
(Designation¹⁰)
Membership Number

Illustration 4: Practitioner's report for an engagement to compile financial statements using a basis of accounting selected by management of an entity for financial information required for management's own purposes.

- Financial statements prepared using a special purpose financial reporting framework, intended for use only by the management of a company for management's own purposes.
- The financial statements incorporate certain accruals, and comprise only a balance sheet, a Statement of Profit and Loss, and a single note that refers to the basis of accounting used for the financial statements.
- The financial statements are intended for use only by management.
- Distribution and use of the practitioner's report is restricted to management.

ACCOUNTANT'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the balance sheet of ABC Company as at March 31, 20XX and a Statement of Profit and Loss for the year then ended.

We performed this compilation engagement in accordance with Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements on the basis of accounting described in Note X to the financial statements. We have complied with relevant ethical requirements.

¹⁰ Partner or Proprietor, as the case may be.

I.788 Auditing Pronouncements

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with the basis of accounting described in Note X.

Note X states the basis on which these financial statements are prepared, and their purpose is described in Note Y. Accordingly, these financial statements are for your use only, and may not be suitable for other purposes.

Our compilation report is intended solely for your use in your capacity as management of ABC Company, and should not be distributed to other parties.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Compilation Report)
(Designation¹¹)
Membership Number

Illustration 5: Practitioner's report for an engagement to compile financial information that is an element, account or item, being [insert appropriate reference to information required for a regulatory compliance purpose].

- Financial information prepared for a special purpose, i.e., to comply with financial reporting requirements established by a regulator, in accordance with provisions established by the regulator prescribing the form and content of the financial information.
- The applicable financial reporting framework is a compliance framework.
- The financial information is intended to meet the needs of particular users, and use of the financial information is restricted to those users.
- Distribution of the practitioner's report is restricted to the intended users.

ACCOUNTANT'S COMPILATION REPORT

[To the Management of ABC Company¹²]

We have compiled the accompanying schedule of [*identify the compiled financial information*] of ABC Company as at March 31, 20XX ("the Schedule") based on information you have provided.

We performed this compilation engagement in accordance with Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of the Schedule as prescribed by [*insert name of or reference to the relevant regulation*]. We have complied with relevant ethical requirements.

¹¹ Partner or Proprietor, as the case may be.

¹² Alternatively, the appropriate addressee specified in the applicable financial reporting requirements.

This Schedule and the accuracy and completeness of the information used to compile it are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile the Schedule. Accordingly, we do not express an audit opinion or a review conclusion on whether the Schedule is prepared in accordance with *[insert name of or reference to applicable financial reporting framework as specified in the relevant regulation]*.

As stated in Note X, the Schedule is prepared and presented on the basis prescribed by *[insert name of or reference to the applicable financial reporting framework as specified in the relevant regulation]*, for the purpose of ABC Company's compliance with *[insert name of or reference to the relevant regulation]*. Accordingly, the Schedule is for use only in connection with that purpose and may not be suitable for any other purpose.

Our compilation report is intended solely for the use of ABC Company and Regulator F, and should not be distributed to parties other than ABC Company or Regulator F.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Compilation Report)
(Designation¹³)
Membership Number

¹³ Partner or Proprietor, as the case may be.

PART-III

GUIDANCE NOTE ON INDEPENDENCE OF AUDITORS (REVISED)*

1. INTRODUCTION

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

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

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

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

“Independence is:

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

* Issued in January, 2005. This Guidance Note replaces the Guidance Note published in ‘The Chartered Accountant’, June 1968, p. 670–672.

III.2 Auditing Pronouncements

conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised."

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

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

1.6 The objective of an audit of financial statements, prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

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

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

1.9 The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. This is not self evident in the exercise of the reporting function but also applies to all other professional work. In determining whether a member in practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should

be whether a reasonable person, having knowledge of relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, could conclude that the member has placed himself in a position where his objectivity would or could be impaired.

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

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

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

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

1.13 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of

III.4 Auditing Pronouncements

assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires chartered accountants to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules in the public interest.

2. THREATS TO INDEPENDENCE

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

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

3. SAFEGUARDS TO INDEPENDENCE

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

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

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- When such threats exist, the auditor should either desist from the task or, at the very least, put in place safeguards that eliminate them. All such safeguards measure needs to be recorded in a form that can serve as evidence of compliance with due process.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

3.3 *Provisions contained under the Companies Act, 1956*

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

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

- (i) an officer or employee of the Company;
- (ii) a partner of a person in the employment of an officer or of an employee of the Company;
- (iii) a person who is indebted to the company for an amount exceeding ₹ 1000;
- (iv) a person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding ₹ 1000;
- (v) a person holding any security of that company.

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

3.3.4 Section 314 of the Companies Act, 1956 makes separate provision for the case where an auditor of a Company (whether public or private) is a relative of a director, or manager of a private company of which the director of the company is a director or member. In the case of

III.6 Auditing Pronouncements

such a person he may be appointed as auditor of a company only if such appointment is approved with the consent of the company in general meeting obtained by a special resolution.

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

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

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

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

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

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

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

3.4.2 What distinguishes a profession from a business is that professional service is not rendered with the sole purpose of a profit motive. Personal gain is one but not the main or the only objective. Professional opinion, therefore, frowns upon methods where payment is made to depend on the basis of results. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the

advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the members are prohibited from charging or accepting any remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings.

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

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

“192. Restriction on fees

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

Provided that:

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

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

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

3.4.7 The words “financial statements” used in this clause would cover both reports and certificates usually given after an examination of the accounts or the financial statement or any attest function under any statutory enactment or for purposes of income-tax assessments. This would not however, apply to cases where such statements are prepared by members in

III.8 Auditing Pronouncements

employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) Where a member is a director

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

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

III.10 Auditing Pronouncements

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

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

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

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

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

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

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

OR

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

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

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

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

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

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

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

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

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

X XX XXX XXXX

III.12 Auditing Pronouncements

- (8) accepts a position as auditor previously held by another chartered accountant or a restricted state auditor without first communicating with him in writing;
- (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with.”

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

3.4.23 Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 provided that an auditor of the company before accepting the appointment, should ascertain from the auditor whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with. Section 224 of the Companies Act, 1956 contains several provisions in the matter of appointment of auditors in different circumstances and situations whereas Section 225 laid down the procedure which must be followed whenever a company desires to change its auditor. Also that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory to ascertain from the company that the appropriate procedure in the matter of appointment has been faithfully followed. Independence of auditor is a concept to be addressed through its all the possible aspects and the message of Clause (8) & (9) is to ensure that an auditor should be conscious about this aspect from the very point of accepting the position of an auditor.

4. CONCLUSION

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

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

GUIDANCE NOTE ON AUDIT OF INVENTORIES*

The following is the text of the Guidance Note on *Audit of Inventories*, issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)¹ issued by the Institute.

1. Para 2.1 of the “Preface to the Statements on Standard Auditing Practices²” issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Inventories, Chapter 5 of the *Statement on Auditing Practices*, titled “Inventories”, shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.³

INTRODUCTION

3. Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course.⁴ Inventories normally comprise raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.⁵

* Issued in November, 1994.

** Now known as the Auditing and Assurance Standards Board (AASB).

¹ Now known as Engagement Standards.

² The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

³ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

⁴ Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of ‘insurance spares’) are normally capitalised.

⁵ The audit procedures, relating to shares debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are similar to those followed for audit of investments. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.

III.14 Auditing Pronouncements

4. Inventories normally constitute a significant portion of the total assets, particularly in the case of manufacturing and trading entities as well as some service rendering entities. Audit of inventories, therefore, assumes special importance.
5. The following features of inventories have an impact on the related audit procedures:
 - (i) By their very nature, inventories normally turn over rapidly.
 - (ii) Inventories are susceptible to obsolescence and spoilage. Further, some of the items of inventory may be slow-moving while others may follow a seasonal pattern of movement.
 - (iii) Inventories are normally movable in nature, although there may be some instances of immovable inventories also, e.g., in the case of an entity dealing in real-estate.
 - (iv) All the items of inventory may not be located at one place but may be held at different locations such as factories and warehouses, or with third parties such as selling agents.
 - (v) The individual items of inventory may not be significant in value, but taken together, they normally constitute a significant proportion of total assets and current assets of manufacturing, trading and certain service entities.
 - (vi) Physical condition (e.g., stage of completion of work-in-process in certain industries) and existence of certain items of inventories may be difficult to determine.
 - (vii) Valuation of inventories may involve varying degrees of estimation, including expert opinions, e.g., in the case of jewelry.

INTERNAL CONTROL EVALUATION

6. The auditor should study and evaluate the system of internal control relating to inventories, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to inventories⁶:
 - (a) The control procedures should provide for segregation of such functions whose combination may permit the commitment or concealment of fraud or error; for example, persons undertaking the physical verification of stocks should be different from those responsible for store-keeping in respect of those stocks.
 - (b) The stores procedures should provide for the use of pre-numbered standardized forms.
 - (c) There should be a system of cross-checking the data generated by different operating departments.
7. The auditor should also review specific controls over receipts, issues, physical inventories, and inventory records.

VERIFICATION

8. As in the case of other assets, the responsibility for properly determining the quantity and

⁶ The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative discussion on internal controls in relation to inventories.

value of inventories rests with the management of the entity. It is, therefore, the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will normally include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence.

9. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (Standard on Auditing (SA) 500, Audit Evidence). In carrying out an audit of inventories, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- Existence - that all recorded inventories exist as at the year-end.
- Ownership - that all inventories owned by the entity are recorded and that all recorded inventories are owned by the entity.
- Valuation - that the stated basis of valuation of inventories is appropriate and properly applied, and that the condition of inventories is recognised in their valuation.

Verification of inventories may be carried out by employing the following procedures:

- (a) examination of records;
- (b) attendance at stock-taking;
- (c) obtaining confirmations from third parties;
- (d) examination of valuation and disclosure; and
- (e) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

EXAMINATION OF RECORDS

10. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

11. The auditor may come across cases where the entity does not maintain detailed stock records other than the basic records relating to purchases and sales. In such situations, the auditor would have to suitably extend the extent of application of the audit procedures discussed in paragraphs 12-22 and 30.

ATTENDANCE AT STOCK-TAKING

12. Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the stock-taking. The extent of auditor's attendance at stock-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity and of the analytical review procedures.

13. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity.

14. There are two principal methods of stock-taking : periodic stocktaking and continuous stock-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date before or shortly after the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous stock-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous stock-taking methods for certain stocks and carry out a full count of other stocks at a selected date.

15. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. An illustrative set of instructions which may be useful in most cases is given in **Appendix I** to this Guidance Note.

16. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the physical condition of inventories.

17. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or dispatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movements. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (e.g., issues from stores to production departments).

18. The auditor should also examine whether the entity has instituted appropriate cut-off procedures to ensure that –

- (a) goods purchased but not received have been included in the inventories and the liability has been provided for;
- (b) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

19. The auditor should review the original physical verification sheets and trace selected items including the more valuable ones into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., stock statements submitted to banks.

20. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for.

21. Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed in paragraphs 16-20 above, pay greater attention to ascertaining whether the management:

- (a) maintains adequate stock records that are kept up-to-date;
- (b) has satisfactory procedures for physical verification of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and
- (c) investigates and corrects all material differences between the book records and the physical counts.

22. The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

CONFIRMATIONS FROM THIRD PARTIES

23. Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. A proforma letter of request for confirmation to be used in such cases is given in **Appendix II** to this Guidance Note. Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks. **Appendix-III** to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

EXAMINATION OF VALUATION AND DISCLOSURE

24. The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis.

III.18 Auditing Pronouncements

25. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles⁷ involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Council of the Institute of Chartered Accountants of India.

26. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the stock sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories.

27. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may examine the variances from actuals and, where these are significant, ensure that appropriate adjustment is made to the inventories.

28. The auditor should examine the evidence supporting the assessment of net realizable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realizable value.

29. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

ANALYTICAL REVIEW PROCEDURES

30. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories:

- (i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;
- (ii) comparison of closing stock quantities and amounts with those of the previous year;
- (iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;
- (iv) comparison of the composition of the closing stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;
- (v) comparison of current year gross profit ratio with the gross profit ratio for the previous year;

⁷ It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1988 uses the words "normally accepted accounting principles".

- (vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;
- (vii) comparison of yield with the corresponding figure for the previous year;
- (viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;
- (ix) comparison of significant ratios relating to inventories with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

SPECIAL CONSIDERATIONS IN CASE OF WORK-IN-PROCESS

31. In general, the audit procedures regarding work-in-process are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-process for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (e.g., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary.

32. In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work-in-process may be impracticable. In such cases, the auditor should lay greater emphasis on ascertaining whether the system, from which the work-in-process is ascertained, is reliable. It may also be useful for the auditor to examine the subsequent records of production/sales.

MANAGEMENT REPRESENTATIONS

33. The auditor should obtain from the management of the entity, a written statement describing in detail, the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding inventories is given in **Appendix IV** to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in a composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

34. The auditor should maintain adequate working papers regarding audit of inventories. He should maintain on his audit file a summary of each inventory as also the details regarding the extent of his verification. The management representation letter concerning inventories should also be maintained on the audit file.

**Illustrative Set of Instructions to be Issued by the
Client to its Staff Responsible for Stock-Taking**
(Ref. Paragraph 15)

This Appendix contains an illustrative set of instructions which may be issued by the client to the staff responsible for stock-taking. The Appendix also lists special instructions in respect of stocks held by others and work-in process.

The annual physical examination of inventories of the entity is to be carried out on 31st March. The work will commence at 8.00 A.M. on 31st March, and there will be no movement of inventories during their physical examination.

1. Mr. AB will be in overall charge of the physical counting.
2. Messrs....., Auditors, will depute their staff to observe the work performed by us. It should be remembered that they are not responsible for any part of the stock-taking.
3. You are responsible for the physical counting of all stocks in (state here the exact area for which the person is responsible e.g., Block B of Godown No. 2, or in the open yard on south of factory, etc.). You are not concerned with similar items of stock which may be stored at other locations.

How to proceed with the work

4. At 8 A.M. you should present yourself in the office of Mr. AB where you will be handed over a bunch of inventory tags. You should ensure that you have in your possession a sufficient number for your needs. You should also have in your possession a pen, blank papers, a measuring tape, (state here any other instrument which is required for measurement, counting, weighing etc.). Please ensure that for all items in your area for which weighing or measuring is required, the necessary apparatus is available.

Procedure for tagging

5.1 You should place a tag on each pile, box, bin, etc., which is counted by you after recording the quantity, description, part number, condition of the stocks to the extent known (e.g., damaged stocks), etc., on the tag. You should proceed in proper order so as to ensure that no items are omitted. When the work of counting is completed you should hand over the remaining tags including soiled and damaged tags to Mr. PQ.

5.2 All items are required to be measured, weighed or counted in order to ascertain the exact quantity on hand. However, in respect of small items of in significant value, such as bolts, nuts (state here any other items which are known to be of small value), the quantities on hand may be estimated without actual counting etc. In the latter case, please state "estimated" on the tag.

5.3 Please ensure that proper identification is made by part number, description, etc., and that in the case of work-in-process, the last operation performed is clearly specified in accordance with the schedule attached to this Memorandum. No movement of any stock from one location to another should take place during the period of stock checking.

5.4 Where bin cards are kept on the bins or job tickets are attached to items in process, you should not merely copy the quantities shown on those documents to the tag without verification. All alterations made on the tags should be initialled and quantities should be recorded in ink.

5.5 Mr. PQ is responsible for the control over tags in use. For this purpose, he should prepare a schedule in the attached Form.

5.6 After obtaining the permission of the auditors⁸, instructions will be issued for the removal of the tags and a suitable person should be sent around in each department to detach the detachable portion of the tags, leaving the counterpart in the proper position. When they are collected, all such tags should be brought back to a central location, placed in serial order and tallied with the schedule prepared by Mr. PQ. After this has been done, the tags will be released to the Accounts Department which is concerned with the preparation of the inventory. Later on, when the inventory has been prepared, a check should be possible to see whether all the tags have been listed.

5.7 After the work of counting has been completed, Mr. AB, who is in overall charge of stock-taking, will make a visit to each area in order to ascertain that all bins, boxes, etc., bear a tag and make a check of the quantities shown therein. At this point, the auditors will carry out further observation and make such test checks as they consider necessary.

5.8 The counterparts of the tags should be left on the relevant bins or piles for a period of at least one month and the quantity shown on the counterparts of the tag should be used as the opening balance of the bin card for the subsequent period.

Procedure for preparing stock sheets

6.1 Separate listings under the following broad heads should be prepared:

- (i) Raw materials, including components
- (ii) Work-in-process
- (iii) Finished goods, including by-products
- (iv) Maintenance supplies and stores and spare parts
- (v) Loose tools

Defective, damaged, obsolete, excess or slow-moving stocks should be listed separately under each of the above categories.

6.2 It should be examined that the stock cards, bin cards, tags or other stock records are posted up-to-date so that items can be traced and verified in these records, simultaneously with the physical checking of stocks.

6.3 A list of excesses and shortages should be drawn up at the time of physical stock-taking.

⁸ It is presumed that the auditors or their representatives are present at the time of stock-taking.

III.22 Auditing Pronouncements

6.4 Stocks belonging to third parties and remaining in custody of the entity should be separately identified from the entity's own stock. A separate listing should be prepared for all such items of stocks.

6.5 Defective, damaged, obsolete, excess or slow-moving stocks should be kept separate from other items.

6.6 Counters and checkers should sign or initial the stock sheets for the work done by them.

Stocks held by others

7.1 The following steps be taken for stocks belonging to the entity but held by others:

- (i) A separate listing for such stocks be prepared.
- (ii) A letter should be sent to such persons to confirm the stocks held by them directly to the auditor.
- (iii) An authority to inspect stocks held by third parties should be given to the auditor where the same is considered necessary by the auditor.
- (iv) An independent record for such goods be kept by the entity.

7.2 The above steps should also be taken for stocks given on loan or received on loan.

Work-in-Process

8.1 With regard to work-in-process, the following instructions be given to the staff members concerned:

- (i) A separate listing for work-in-process be prepared.
- (ii) The internal records kept by the entity be written up-to-date.
- (iii) If the amount of work-in-process is determinable from production records, the same be kept up-to-date.
- (iv) A list of opening work-in-process be kept ready at the time of stock-taking.

Appendix II

Illustrative Letter of Confirmation of Inventories Held by Others

[Ref. Paragraph 23]

(Letterhead of Entity)

[Date]

[Name and address of holder of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning our inventories held by you for [state here the purpose of holding of inventories by the third party] as of the close of business on

According to our records, you held the following inventories as of that date:

Description	Quantity
.....
.....

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

Appendix III

**Illustrative Letter of Confirmation – Inventories
Held by the Entity on Behalf of Others**

[Ref. Paragraph 23]

[Letterhead of Entity]

[Date]

[Name and address of owner of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning your inventories held by us for [state here the purpose of holding of inventories by the entity as of the close of business on _____].

According to our records, we held the following inventories as of that date:

Description	Quantity
.....
.....

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

Representation Letter for Inventories

[Ref. Paragraph 33]

The following is a sample representation letter for inventories. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X limited as of....., 19...., and for the year then ended, we make, to the best of our knowledge and belief, the following representations concerning inventories.

1. Inventories at the year-end consisted of the following:

Raw Materials (including components)	₹ _____
Work-in-Process	₹ _____
Finished Goods (including by-products)	₹ _____
Maintenance supplies and Stores and Spare Parts	₹ _____
Loose Tools	₹ _____
Others (specify each major head separately)	₹ _____
Total	₹ _____

2. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on (date/dates of physical verification), except as follows:⁹

.....

.....

⁹ Where physical verification of inventories is carried out at a date other than the closing date, this paragraph may be modified as below:

Inventories recorded in the books as at.....(date of balance sheet) aggregating to ₹ are based upon the physical inventories taken as at (date of physical verification) by actual count weight or measurement. The material discrepancies noticed on physical verification of stocks as compared to book records have been properly dealt with in the books of account and subsequent transactions recorded in the accounts fairly reflect the changes in the inventories up to (balance sheet date).

3. Except as set out below, all goods included in the inventory are the property of the entity and are not subject to any charge, and none of the goods are held as consignee for others or as bailee:

.....

4. All inventories owned by the entity, wherever located, have been recorded, including goods sent on consignment.

5. Inventories do not include goods sold to customers for which delivery is yet to be made.

6. Inventories have been valued on the following basis/bases:

Raw Materials (including components)

Work-in-Process

Finished Goods (including by-products)

Maintenance supplies and Stores and Spare Parts

Loose Tools

Others (specify each major head separately)

(In describing the basis/bases of valuation, the method of ascertaining the cost (e.g. FIFO, Average Cost or LIFO) should also be stated. Similarly, the extent to which overheads have been included in the cost should also be stated.)

7. The following provisions have been made in respect of excess, slow moving, damaged, or obsolete inventories and these, in our view, are adequate.

.....

8. No item of inventories has a net realizable value in the ordinary course of business which is less than the amount at which it is included in inventories.

9. The basis/bases of valuation is/are the same as that/those used in the previous year, except as set out below:

Class of Inventory	Basis of valuation		Effect of change in Basis of Valuation
	This year	Last year	
.....	
.....	

Yours faithfully,

(Signature of responsible official of the entity)

Clarification***

Auditor's Duties where Inventories are Stated to be "As Valued and Certified by the Management" in Financial Statements

(Refer Paragraph 33)

It has been observed that in some cases, inventories are described in the financial statements as "Stocks (as valued and certified by the management)". The use of such an expression may lead the users of the financial statements to believe that the auditor merely relies on the management's certificate without carrying out any other appropriate audit procedures to satisfy himself about the existence and valuation of inventories.

The Institute of Chartered Accountants of India has issued a Guidance Note on Audit of Inventories, which recommends the procedures to be followed by the auditors in conducting the audit of inventories. Para 33 of the Guidance Note, *inter alia*, recommends as below:

"The auditor should obtain from the management of the entity, a written statement describing in detail the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information."

In view of the above, the Council of the Institute hereby clarifies that despite the expression "as valued and certified by the management", the duties and responsibilities of the auditors with regard to audit of inventories are not diminished. Thus, in order that the auditor's role with regard to inventories is properly appreciated by the users of the financial statements, the auditor may advise his clients to omit the words "as valued and certified by the management", when describing inventories in the financial statements.

*** Published in September, 1999 issue of "The Chartered Accountant", p.66.

GUIDANCE NOTE ON AUDIT OF DEBTORS, LOANS AND ADVANCES*

The following is the text of the Guidance Note on Audit of Debtors, Loans and Advances issued by the Auditing Practices Committee (APC)⁺ of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)¹ issued by the Institute.

1. Paragraph 2.1 of the “Preface to the Statements on Standard Auditing Practices”² issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Paragraph 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Debtors, Loans and Advances, Chapter-7 of the *Statement on Auditing Practices*, titled ‘Debtors, Loans and Advances’, shall stand withdrawn. In due course of time, the entire *Statement of Auditing Practices* shall be withdrawn.³

INTRODUCTION

3. Debtors, loans and advances may constitute a significant proportion of the total assets of an entity. Debtors represent the amounts due to an entity for goods sold or services rendered or in respect of other similar contractual obligations, but do not include the amounts which are in the nature of loans or advances. Loans represent the claims of an entity in respect of such contractual obligations as moneys lent. Advances represent payments made on account of, but before completion of, a contract or before acquisition of goods or receipt of services. For purposes of this Guidance Note, debtors, loans and advances include instruments such as bills of exchange, promissory notes and similar other instruments, evidencing debtors, loans

* Published in June, 1994 issue of ‘The Chartered Accountant’.

⁺ Now known as the Auditing and Assurance Standards Board (AASB).

¹ Now known as Engagement Standards.

² The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

³ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

and advances.

4. An important feature of debtors, loans and advances which has a significant effect on the related audit procedures is that these assets are represented only by documentary evidence; they have no physical existence. Moreover, the documentary evidence is generally in the form of invoices, loan documents, etc., prepared by the entity itself. The auditor should take these factors into account in designing his audit procedures.

INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to debtors, loans and advances, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to debtors, loans and advances.⁴

(a) In respect of debtors

- (i) The basis on which credit limits for customers are to be determined should be clearly laid down. The credit limits fixed in respect of individual customers should be approved by an official independent of the sales department. These limits should be checked before orders are accepted from the customers. There should also be a system of periodic review of the credit limits.
- (ii) The procedure should ensure prompt recording of debts and realisations and of linking receipts with outstandings.
- (iii) There should be a procedure for preparation of aging schedule of debtors at regular intervals. The schedules should be reviewed by a responsible official and necessary action initiated in respect of overdue accounts.
- (iv) Statements of account should be sent to all debtors at periodic intervals. They should be prepared and despatched by a person independent of the ledger-keeper. The debtors should be requested to confirm the balances as per the statements with reference to their own records. The confirmations received should be reviewed by a person independent of the ledger-keeper and the person responsible for preparing the statements of account, and necessary action taken in case of discrepancies.
- (v) All material adjustments in debtors' accounts, particularly those relating to rebates, allowances, commissions etc., should require approval of the competent authority. Similarly, any write-off of bad debts should require approval of the competent authority.
- (vi) There should be a system of periodic reconciliation of various debtor balances with related control accounts.

⁴ The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative discussion on internal controls in relation to debtors and loans and advances.

(b) In respect of loans and advances

- (i) As far as possible, the system should specify the following:
 - ◆ total amount up to which loans may be made;
 - ◆ the purposes for which loans may be made;
 - ◆ maximum amount of loans which may be made for each such purpose in individual cases;
 - ◆ the terms on which such loans may be made;
 - ◆ the persons who are authorized to make loans;
 - ◆ procedure for ensuring compliance with relevant legal requirements.
- (ii) All variations in the terms of loans and advances should be duly approved in writing by the competent authority.
- (iii) Where security is taken against the loans, the form and adequacy of security should be reviewed by a responsible official.
- (iv) The loan and security documents should be kept in safe custody of a responsible official. A record of all such documents should be maintained and the documents should be periodically verified with reference to such records.
- (v) The system should provide for identification of cases where principal and/or interest have become overdue or where any other terms are not being complied with.
- (vi) Confirmation of balances should be obtained at periodic intervals in the same manner as in the case of debtors.

VERIFICATION

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out an audit of debtors, loans and advances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- | | | |
|--------------|---|---|
| Existence | - | that all amounts recorded in respect of debtors, loans and advances are outstanding as at the date of the balance sheet. |
| Completeness | - | that there are no unrecorded debtors, loans and advances. |
| Valuation | - | that the stated basis of valuation of debtors, loans and advances is appropriate and properly applied, and that the recoverability of debtors, loans and advances is recognised in their valuation. |
| Disclosure | - | that the debtors, loans and advances are disclosed, classified, and described in accordance with recognised accounting policies and |

III.30 Auditing Pronouncements

practices and relevant statutory requirements, if any.

Verification of debtors may be carried out by employing the following procedures:

- (a) examination of records;
- (b) direct confirmation procedure (also known as 'circularisation procedure');
- (c) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

EXAMINATION OF RECORDS

7. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

8. The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with the related control accounts. Any differences in this regard should be examined.

9. Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant debtors, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

10. While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects:

- (a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
- (b) Whether the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
- (c) Whether transfers from one account to another are properly evidenced.
- (d) Whether provisions for allowances, discounts and doubtful debts are required. In this regard, the auditor should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.

11. The following are some of the indications of doubtful and uncollectible debts, loans and advances:

- (a) The terms of credit have been repeatedly ignored.
- (b) There is stagnation, or lack of healthy turnover, in the account.
- (c) Payments are being received but the balance is continuously increasing.
- (d) Payments, though being received regularly, are quite small in relation to the total

outstanding balance.

- (e) An old bill has been partly paid (or not paid), while later bills have been fully settled.
- (f) The cheques received from the debtor have been repeatedly dishonoured.
- (g) The debt is under litigation, arbitration, or dispute.
- (h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.
- (i) Amounts due from employees, which have not been repaid on termination of employment.
- (j) Collection is barred by statute of limitation.

12. Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorisation should be inspected.

13. In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

14. The auditor should examine whether the contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.⁵

Special Considerations in Case of Loans and Advances

15. In general, the procedure outlined above in regard to debtors is also applicable in the case of loans and advances. However, in the case of loans and advances, the auditor may find greater documentary evidence (in the form of loan and security documents and related correspondence) on which he can place reliance.

16. In the case of loans and advances, an important aspect to be examined by the auditor is whether the entity is empowered to make loans. In many cases, the statute governing the entity may contain restrictions or conditions about the amount of loans, purposes for which loans may be granted, parties to which loans may be granted etc. Similarly, the internal regulations of the entity may also prescribe the procedure to be followed for making the loans. For instance, in the case of companies, sections 292, 295 and 370 place restrictions on the making of loans by companies.⁶ The competence of the borrower to receive the loan may also

⁵ Reference may be made in this regard to Accounting Standard (AS) 4, *Contingencies and Events Occurring after the Balance Sheet Date*, issued by the Institute of Chartered Accountants of India.

⁶ For a detailed study of this aspect, reference may be made to the Institute's publication titled *A Guide to Company Audit*. Similarly, in the case of entities like banks, insurance companies, etc., reference may be made to

III.32 Auditing Pronouncements

affect the legality and, hence, the recoverability of the loan. The auditor should examine the loan documents and other evidence with reference to the above while determining the legality and recoverability of the loans made by the entity.

17. The auditor should ascertain whether the parties to whom loans and advances have been made have complied with the terms and conditions relating to payment of interest, repayment of loans or adjustment of advances, etc. In the case of defaults, e.g., where the repayment of loans or advances or the payment of interest are overdue, the auditor should consider whether such defaults are indicative of unwillingness or inability of the parties concerned to make the payment.

18. The auditor should pay particular attention to loans and advances given to parties in whom directors or persons who are substantial owners of the entity are interested. He should ascertain the purpose of such loans and advances, the terms and conditions on which they have been made as also their recoverability.

19. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, the auditor of a company covered by the Manufacturing and Other Companies (Auditor's Report) Order, 1988⁷, is required to state in his report whether the terms and conditions on which loans and advances have been made are *prima facie* prejudicial to the interests of the company. Similarly, clause (a) of sub-section (1A) of section 227 of the Companies Act, 1956, requires the auditor to inquire "whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

DIRECT CONFIRMATION PROCEDURE

20. The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. It must be recognised, however, that mere confirmation of balance by a debtor does not by itself ensure ultimate recovery. Moreover, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the debtors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

21. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the

the relevant publication(s) of the Institute, e.g., *Guidance Note on Audit of Banks*, *Guidance Note on Audit of Companies Carrying on General Insurance Business*, *Guidance Note on Companies Carrying on Life Insurance Business*, *Guide to Audit of Cooperative Societies*, etc.

⁷ The Department of Company Affairs has notified the Companies (Auditor's Report) Order, 2003 in June 2003 in terms of the powers given to it under section 227(4A) of the Companies Act, 1956.

reason as being the fact that there is a dispute with the particular debtor and the request for confirmation may aggravate sensitive negotiations between the entity and the debtor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the debtor. In such a case, alternative procedures should be applied to debtors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

22. The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

23. The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially misstated.

24. The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request, wherein the debtor is requested to respond only if he disagrees with the balance shown.

25. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in **Appendix I** to this Guidance Note.

26. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances. An illustrative negative form of request letter is given in **Appendix II** to this Guidance Note.

27. In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

28. Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be

III.34 Auditing Pronouncements

circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should select accounts in respect of which provisions have been made or balances have been written off during the period under audit or earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with nil balances. The nature of the entity's business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

29. In appropriate cases, the debtor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the entity's usual trade terms.

30. The method of selection of the debtors to be circularised should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

31. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those debtors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant debtors from whom he receives no replies despite reminders. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

32. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

ANALYTICAL REVIEW PROCEDURES

33. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances:

- (a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;
- (b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;
- (c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;
- (d) comparison of current year's aging schedule with the corresponding figures for the previous year;
- (e) comparison of significant ratios relating to debtors, loans and advances with the similar ratios for other firms in the same industry, if available;
- (f) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

DISCLOSURE

34. The auditor should satisfy himself that the debtors, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

MANAGEMENT REPRESENTATIONS

35. The auditor should obtain from the management of the entity, a written statement regarding recoverability of debtors and loans and advances and their classification for balance sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to debtors, loans and advances, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding debtors, loans and advances is given in **Appendix III** to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

36. The auditor should maintain adequate working papers regarding audit of debtors, loans and advances. Among others, he should maintain on his audit file, the confirmations received as well as any undelivered letters of request for confirmation. The management representation letter concerning debtors, loans and advances should also be maintained on the audit file.

Appendix I

Illustrative Letter of Confirmation to be Sent to Debtors-Positive Form

[Ref. Paragraph 25]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs..... due by you as on, as shown by our books, is correct. The details of the balance are as under:⁸

<i>Invoice No.</i>	<i>Date</i>	Order Reference or Tender No. etc. (To be used Particularly for Government Customers)	Acceptance or Amount
Total			
Less : Advance received			
Net Amount due by you (Rs.)			_____

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

Kindly return this form in its entirety.

Yours Faithfully,

(Signature of responsible official of the entity)

.....

⁸ In case the list of invoices forming the balance is too large, these details may not be given.

(Do not perforate the form at this point)

(Name and Address of entity)

(A) We confirm that the above stated amount is correct as at _____

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at _____ as per our records are as below:

Invoice No.	Date	Order Reference	Amount
		Total	_____
		Less: Advanced paid	_____
		Net Amount due from us (Rs.)	_____
		Net Amount due from us (Rs.)	_____

Date

(Signature of debtor/responsible official)

Appendix II

Illustrative Letter of Confirmation to be Sent to Debtors-Negative Form

[Ref. Paragraph 26]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of Rs. due by you as on _____ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:⁹

Invoice No.	Date	Order Reference or Acceptance or Tender No. etc. (To be used particularly for Government Customers)	Amount
		Total	_____
		Less: Advanced paid	_____
		Net Amount due by you (Rs.)	_____

⁹ In case the list of invoices forming the balance is too large, these details may not be given.

III.38 Auditing Pronouncements

If you do not notify our auditors of any difference within ten days of the date of this letter, it will be presumed that the balance stated above is correct.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

Appendix III

Representation Letter for Debtors, Loans and Advances

[Ref. Paragraph 35]

The following is a sample representation letter for debtors, loans and advances. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of, 19.., and for the year then ended, we certify that the following items appearing in the books as at(date of the Balance Sheet) are considered good and fully recoverable with the exception of those specifically shown as "doubtful" in the Balance Sheet.

Sundry Debtors Rs.

Loans and Advances¹⁰ Rs.

Yours faithfully,

(Signature of responsible official of the entity)

¹⁰ It may be pointed out that a similar certificate regarding deposits made by the entity may also be obtained by the auditor in appropriate cases.

GUIDANCE NOTE ON AUDIT OF INVESTMENTS*

The following is the text of the Guidance Note on Audit of Investments issued by the Auditing Practices Committee (APC)¹ of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)² issued by the Institute.

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices"³ issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee, It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn.⁴ With the issuance of this Guidance Note on Audit of Investments, Chapter 4 of the *Statement on Auditing Practices*, titled "Investments", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.⁵

* Issued in November, 1994.

¹ Now known as the Auditing and Assurance Standards Board (AASB).

² Now known as Engagement Standards.

³ The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in Vol.I of this Handbook.

⁴ This Guidance Note does not deal with special aspects of audit of investments of retirement benefit plans, life insurance enterprises, mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956. The special aspects of audit of investments of some of these institutions have been dealt with in other publications of the Institute, e.g., *Guidance Note on Audit of Banks*, *Guidance Note on Audit of Companies Carrying on General Insurance Business*, *Guidance Note on Companies Carrying on Life Insurance Business*. It may also be noted that in the case of certain types of entities, e.g., companies, banks, insurance companies, co-operative societies, etc., the question of compliance with the legal requirements assumes special importance. Appendix I to this Guidance Note contains a brief description of the main provisions of the statutes governing these types of entities in so far as they relate to investments. It may be emphasised that the Appendix is only illustrative and not exhaustive. Moreover, the legal requirements may change from time to time and, therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

⁵ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

INTRODUCTION

3. Investments are assets held by an entity for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing entity⁶ Investments are classified as 'current investments' and 'long term investments'. A *current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A *long term investment* is an investment other than a current investment.⁷

4. The following features of investments have an impact on the related auditing procedures:

- (a) Investments constitute a significant portion of the total assets of certain entities like banks, insurance companies, investment companies, trusts, etc. In other cases, the nature, quantum and type of investments may vary from case to case.
- (b) Documentary evidence is generally available for audit verification. A detailed record of acquisition, disposal, etc., of the investments is usually maintained.
- (c) The market values of investments may keep on fluctuating. While in the case of some investments, such fluctuations may not be wide, in the case of others, they may be significant.
- (d) Physical location of documents of title to investments may be different from the one where the acquisition, disposal and recording thereof take place.
- (e) Many investments are readily marketable or can be converted into cash.

INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to investments.⁸

- (a) *Control over acquisition, accretion and disposal of investments*: There should be proper authority for sanction, acquisition and disposal of investments (including renunciation of rights). It should also be ensured that investments are made in accordance with the legal requirements governing the entity as also with its internal regulations, e.g., the provisions of the articles of association, rules and regulations, trust deed, etc.
- (b) *Safeguarding of investments*: The investments should be in the name of the entity as far as possible. The legal requirements in this behalf, if any, should be complied with. There

⁶ It may be clarified that the term 'investments' covers only such securities as are beneficially owned by the entity and not those held by it on behalf of others.

⁷ It may be clarified that inventories, as defined in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Institute of Chartered Accountants of India are not investments. However, the recommendations of this Guidance Note also apply, to the extent relevant to shares, debentures and other securities held as stock-in-trade. Fixed assets (other than investment properties), as defined in Accounting Standard (AS) 10, "Accounting for Fixed Assets", issued by the Institute, are also not investments.

⁸ The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to investments.

should exist a proper system for the safe custody of all scrips or other documents of title to the investments belonging to the entity.

- (c) *Controls relating to title to investments:* It should be ensured that in cases where the title does not pass on to the entity immediately on acquisition, the same is transferred to the entity in due course of time, along with the benefits that might have accrued since the acquisition of the investments. It should be ensured that there is no undue time-lag in the execution of various stages of the transactions.
- (d) *Information controls:* These controls should ensure that reliable information is available for recording acquisitions (including by way of conversion of securities, right issues or other entitlements, under schemes of amalgamation, acquisition, etc.), accretions and disposals, and for ascertaining the market values etc. Detailed records regarding acquisition, disposal etc. of the investments should be maintained along with proper documentation.

VERIFICATION

6. The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Verification of investments may be carried out by employing the following procedures:

- (a) verification of transactions;
- (b) physical inspection;
- (c) examination of valuation and disclosure; and
- (d) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

7. The investments of an entity may take various forms, e.g., they may be in the form of Government securities, shares and debentures, immovable properties, etc. The following paragraphs discuss the audit steps for verifying investments, with special reference to investments in the form of shares, debentures and other securities.

VERIFICATION OF TRANSACTIONS

8. The auditor should ascertain whether the investments made by the entity are within its authority. In this regard, the auditor should examine whether the legal requirements governing the entity, insofar as they relate to investments, have been complied with and the investments made by the entity are not *ultra vires* the entity. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict, qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the entity.

9. The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs,

III.42 Auditing Pronouncements

receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right or cum-bonus/ex-bonus. He should check whether proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

10. In the case of a rights issue, the offer to the entity contained in the letter of rights should be examined. Where the rights have been renounced or otherwise disposed of or not exercised, the auditor should examine the relevant decision of the appropriate authority in this behalf, as also that the sale proceeds, if any, have been duly accounted for.

11. As regards bonus shares, the intimation to the entity regarding such issue should be examined with a view to ascertaining the receipt and recording of the requisite number of shares by the entity.

12. Where the amounts of purchases or sales of investments are substantial, the auditor may check the prices paid/received with reference to the stock exchange quotations, where available, on or about the date of purchase or sale.

PHYSICAL INSPECTION

13. The auditor should carry out a physical inspection of investments in the form of shares, debentures and other securities. (Special considerations apply in the case of investments in the form of immovable properties, as discussed in paragraph 24.) In the case of certain entities (e.g., insurance companies), physical inspection of investments is a statutory requirement.

14. The depository services and scripless trading are becoming increasingly popular in India. Depository services involve custody of documents of title to investments such as certificates, scrips and deeds and thus avoid their physical handling by the investor. The Public Debt Office of the Reserve Bank of India offers such services to facilitate trading in Government Securities. Authorised institutions such as banks, financial institutions etc., which have individual ledger accounts with the Public Debt Office can trade in government securities between themselves by issuing and accepting Bankers' Receipts. In case of such transactions, the auditor should verify the periodic reconciliation of balances as per the records of the entity and those as per the Public Debt Office.

15. Apart from the Public Debt Office, there are now a number of other custodial organisations whose services are being utilised by banks, large investors, institutional investors, mutual funds etc. The concept of the National Depository System (NDS) is also under development. This system is aimed at eliminating physical movement of securities for purchases and sales. Wherever the services of any of these custodial or depository organisations are being used by the entity under audit, the auditor should redesign his audit procedures to ensure that there is an effective system of periodic reconciliation of balances as per the records of the entity and those as per the records of the custodial or depository organisation. The auditor should also examine the certificates issued by such organisations confirming the holdings of the entity. The concept of scripless trading being introduced by the

National Stock Exchange and the OTC Exchange of India also envisage elimination of movement of title deeds of securities. In such cases, the auditor should verify the interim and other acknowledgments issued by dealers as well as the year-end confirmation certificates of the depository organisations.

16. The investments held by the entity in its own custody should normally be examined at the close of business on the last day of the year. In case this is not possible, the auditor should carry out the inspection on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. Where a substantial number of investments are kept by the entity in its custody, the auditor should carry out a surprise inspection of the investments on hand at least once in the year in addition to his year-end examination. He should take particular care to see that only the investments belonging to the entity are produced to him. This aspect assumes special importance in the case of entities like banks which hold investments on their own account, in the form of securities lodged by the customers against loans and advances, and on behalf of the PMS clients.

17. Where investments are held by any other person on behalf of the entity, e.g., by banks, the auditor should examine the certificates received from them. Such certificates should preferably be received directly by the auditor. A suggested form of bank confirmation certificate is given in **Appendix II** to this Guidance Note.

18. In case investments are held by persons other than banks, the auditor should ensure that there is justification for it, e.g., securities in the custody of brokers or with the company concerned for transfer, consolidation, splitting up conversion, etc. Evidence of securities held with others should be examined and, in appropriate cases, physical inspection of the relevant documents may be made, to the extent possible, in the course of audit. Where the investments are recorded at an office other than the one where the documents of title thereto are physically located, the local auditor may be requested to verify the same.

19. If the investments are held otherwise than in the name of the entity (e.g., in the name of nominees/trustees), the auditor should ascertain the reasons for the same and examine the relevant documentary evidence (e.g., written confirmations from the nominees, trustees, etc.) supporting the real/beneficial interest of the entity in the investments.

20. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, in the case of a company, the auditor should also carry out the procedures outlined in paragraphs 21-23 below.

21. Where shares are held not in the name of the company but in the name of a director, officer, etc., the auditor should examine whether the declaration referred to in section 187-C of the Companies Act, 1956 has been properly made.

22. The auditor should keep in mind the provisions of section 227(1A)(c) which requires that

III.44 Auditing Pronouncements

the auditor of a company, not being an investment company within the meaning of section 372 of the Companies Act, 1956 or a banking company, should enquire whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.⁹

23. In case the entity is a finance, investment, chit fund, *nidhi* or mutual benefit company and is dealing or trading in shares, securities, debentures or other investments, the auditor has to state in his report (by virtue of the requirements of the Manufacturing and Other Companies (Auditor's Report) Order, 1988**, issued under section 227(4A) of the Companies Act, 1956) whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein as also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemptions granted under section 49 of the Companies Act, 1956.¹⁰

IMMOVABLE PROPERTIES

24. Where immovable properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as fixed assets.¹¹

EXAMINATION OF VALUATION AND DISCLOSURE

25. The auditor should satisfy himself that the investments have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.¹² **Appendix III** to this Guidance Note discusses, by way of illustration, the disclosure requirements of some of the Acts. The auditor should also examine whether the method of valuation followed by the entity is consistently applied.

26. The auditor should examine whether, in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty, brokerage, etc., is included in the cost of investments.

27. The auditor may ascertain the market value of the quoted securities from official quotations of the stock exchange. In case of unquoted securities, the auditor should ascertain the method adopted by the entity for determining the market value of such securities. He

⁹ For a detailed discussion on this aspect reference may be made to the "Statement on Qualification in Auditor's Report", issued by the Institute of Chartered Accountants of India (ICAI).

(The readers may note that the Council, at 269th meeting, held from July 18 to 20, 2007, decided to withdraw the "Statement on Qualification in Auditor's Report" except paragraphs 2.1 to 2.30 dealing with reporting under section 227 (1A) of the Companies Act, 1956 and to rename the Statement as "Statement on Reporting under section 227(1A) of the Companies Act, 1956".)

** Currently, the Companies (Auditor's Report) Order, 2003 (Revised 2005) is in force in terms of section 227(4A) of the Companies Act, 1956.

¹⁰ For a detailed discussion on this aspect, reference may be made to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

¹¹ Reference may be made in this regard to the *Guidance Note on Audit of Fixed Assets*, issued by the Institute of Chartered Accountants of India.

¹² Reference may be made in this regard to Accounting Standard 13, *Accounting for Investments*, issued by the Institute of Chartered Accountants of India.

should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as break-up value method, capitalisation of yield method, yield to maturity method, etc. In the case of investments other than in the form of securities (e.g., rare paintings), the auditor should examine that the market value has been ascertained on the basis of authentic market reports.

ANALYTICAL REVIEW PROCEDURES

28. As a measure of judging the overall reasonableness of the amounts attributed to investments, the auditor may relate the amount of income received from investments with the corresponding figures of investments and compare this ratio with the similar ratio for the previous years. For this purpose, investments may be classified into appropriate categories. Thus, in the case of fixed interest-bearing securities, the auditor may relate the amount of interest earned with the face value of the related securities. In the case of other securities, the auditor may review the schedule of dividend and other returns and the schedule of investments prepared by the entity and judge their reasonableness.

MANAGEMENT REPRESENTATIONS

29. The auditor should obtain from the management of the entity a written statement regarding classification and valuation of investments for Balance Sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to investments, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding investments is given in **Appendix IV** to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

30. The auditor should maintain adequate working papers regarding audit of investments. Among others, he should maintain on his audit file, the management representation letter concerning investments.

Appendix I

Legal Requirements Relating to Investments

(Ref. Paragraph 2)

This Appendix contains an illustrative description of the legal provisions regarding investments as contained in the Companies Act, 1956, Banking Regulation Act, 1949, Insurance Act, 1938, and the Cooperative Societies Act, 1912. It may be emphasised that this Appendix is only illustrative in nature and is not intended to give an exhaustive description of all the relevant legal requirements applicable to different types of entities. Moreover, the legal requirements

III.46 Auditing Pronouncements

may change from time to time and therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

Provisions of the Companies Act, 1956

The main relevant sections are section 49, section 108, section 292, section 293(1)(c) and section 372, besides requirements of inquiry/reporting under sections 227(1A) and 227(4A).

Section 49 provides that, subject to certain exceptions, investments made by a company on its own behalf shall be made and held by it in its own name.

Section 108 lays down the mode of transfer of shares and debentures and prescribes the period of validity of blank transfers. Sections 108A-108I lay down certain restrictions on acquisition and transfer of shares.

Section 292 provides that the power to invest the funds of a company shall be exercised by its Board of Directors on behalf of the company only by means of resolutions passed at meetings of the Board. However, the Board may, by a resolution passed at a meeting, delegate this power to any of its committees, the managing director, the manager or any other principal officer of the company. In such case, every resolution delegating the power to invest the funds of the company shall specify the total amount upto which the funds may be invested and the nature of the investments which may be made, by the committee or the person to whom the power to invest is so delegated.

Section 293(1)(c) provides that the Board of Directors of a public company, or of a private company which is a subsidiary of a public company, shall not invest otherwise than in trust securities, the amount of compensation received by it in respect of the compulsory acquisition of any undertaking or of any premises or properties used for any such undertaking except with the consent of the company in a general meeting.

Section 372 provides that a company, whether by itself or together with its subsidiaries, shall not be entitled to acquire, by way of subscription, purchase or otherwise, the shares of any other body corporate except to the extent and except in accordance with the restrictions and conditions, specified in the section.

Provisions of the Banking Regulation Act, 1949

Section 19 of the Act provides that no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less. The above restriction, however, does not apply to the holding by a banking company of shares in its subsidiary. A banking company is also prohibited from holding shares, whether as pledgee, mortgagee or absolute owner, in any company in the management of which, any managing director or manager of the banking company is in any manner concerned or interested.

Section 24 of the Banking Regulation Act provides that every banking company shall maintain in India in cash, gold or unencumbered approved securities, an amount which shall not, at the close of business on any day, be less than twenty-five per cent or such other percentage not

exceeding forty, as the Reserve Bank of India may from time to time specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight.

The above provisions also apply to the State Bank of India and its subsidiaries and the nationalised banks.

Provisions of the Insurance Act, 1938

Section 27(B) of the Insurance Act, 1938 provides that no insurer carrying on general insurance business can invest or keep invested any part of his assets otherwise than in any of the approved investments or in other investments which satisfy certain conditions or in certain prescribed assets which are deemed to be approved investments for the purposes of this section.

A general insurance company can invest any part of its assets in investments other than the investments mentioned above, provided that (i) the total amount of all such investments does not exceed 25 per cent of its assets and (ii) the making or the continuance of the investment is with the consent of all the directors, present and eligible to vote, at a meeting, special notice of which, has been given to all directors, then in India. All such investments including investments in which any director is interested must be reported without delay to the Controller of Insurance with full details of the investments and the extent of any director's interest in any such investment.

An insurer cannot invest or keep invested any part of his assets in the shares of any one banking company or investment company more than (a) ten per cent of his assets, or (b) two per cent of the subscribed share capital and debentures of the banking company or investment company concerned, whichever is less.

Further, an insurer cannot invest or keep invested any part of his assets in the shares or debentures of any one company other than a banking company or investment company more than (a) ten per cent of his assets, or (b) ten per cent of the subscribed share capital and debentures of the company, whichever is less.

Where an investment is in partly paid-up shares, the uncalled liability on such shares shall be added to the amount invested, for the purpose of determining whether such investment exceeds the limits referred to above. However, an insurer can subscribe to the right shares notwithstanding the limits specified above.

These limits do not apply to an investment made by an insurer in the shares of any other insurance company carrying on insurance or re-insurance business in India.

The Controller of Insurance can waive for a specified period and with certain conditions, the limits specified above if, on an application from the insurer, he is satisfied that special grounds exist warranting such waiver.

An insurer cannot invest or keep invested any part of his assets in the shares or debentures of any private company.

III.48 Auditing Pronouncements

Provisions of the Cooperative Societies Act, 1912

Section 32 of the Cooperative Societies Act, 1912 provides that a registered society can invest or deposit its funds only:

- (a) in Government Savings Banks;
- (b) in any of the securities specified in section 20 of the Indian Trusts Act, 1882;
- (c) in the shares or on the security of any other registered society;
- (d) with any bank or person carrying on the business of banking, approved for this purpose by the Registrar; or
- (e) in any other mode permitted by the rules.

Appendix II

Illustrative Letter of Confirmation – Investments Held by Banks

(Ref. Paragraph 17)

[Letterhead of entity]

[Date]

.....(Bank)

.....

.....

Dear Sirs,

For audit purpose, kindly send directly to our auditors (name and address of the auditors) a certificate regarding all the shares, debentures and other securities belonging to us but lying with you as (i) security against loans and advances to us, or (ii) in safe custody account at the close of business on

For your convenience, we enclose in duplicate a form in which the certificate may be sent. Please send one copy to our auditors, retaining the other for your records. Should you find the space on the form insufficient to contain all the relevant information, please attach a separate statement.

We would request you to state NIL wherever applicable.

Yours faithfully,

(to be signed by person authorised to operate accounts)

Appendix III

Disclosure Requirements Relating to Investments

(Ref. Paragraph 25)

To illustrate the manner of disclosure of investments in the financial statements, this Appendix discusses the requirements of the Companies Act, 1956, the Banking Regulation Act, 1949, and the Insurance Act, 1938, insofar as they relate to disclosure of information regarding investments in the financial statements prepared and presented in accordance with the provisions of these statutes. As regards the co-operative societies, the form and content of their financial statements are governed by the rules framed by the State Government concerned. It may be emphasised that, in every case, there should be an adequate disclosure of all relevant information to facilitate proper understanding of the financial statements by the users.

Requirements of the Companies Act, 1956

Schedule VI to the Companies Act, 1956 requires the disclosure of investments in the balance sheet as below:

- (1) Investments in Government or Trust Securities.
- (2) Investments in shares, debentures or bonds (showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies).
- (3) Immovable properties.
- (4) Investments in the capital of partnership firms.

The above particulars have to be given showing the nature of investments and mode of valuation, for example, cost or market value. Further, the aggregate amount of the company's quoted investments and the market value thereof have to be shown. The aggregate amount of the company's unquoted investments is also required to be shown.

A statement of investments (whether shown under "Investments" or under "Current Assets" as stock-in-trade, separately classifying trade investments and other investments) is required to be annexed to the balance sheet, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures investments have been made (including all investments whether existing on the balance sheet date or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each such body corporate. In the case of an investment company, i.e., a company whose principal business is the acquisition of shares, stocks, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the share of each partner) are required to be given in the statement.

III.50 Auditing Pronouncements

Requirements of the Banking Regulation Act, 1949

The Third Schedule to the Banking Regulation Act, 1949, requires the investments to be classified under the following heads for the purpose of balance sheet presentation:

- I. Investments in India in
 - (i) Government securities
 - (ii) Other approved Securities
 - (iii) Shares
 - (iv) Debentures and Bonds
 - (v) Subsidiaries and/or joint ventures
 - (vi) Others (to be specified)Total:

- II. Investments outside India in
 - (i) Government securities (including local authorities)
 - (ii) Subsidiaries and/or joint ventures abroad
 - (iii) Other investments (to be specified)Total:

- Grand Total: (I &II)

Requirements of the Insurance Act, 1938

The First Schedule to the Insurance Act, 1938 requires the disclosure of investments of an insurer as below: ·

- ◆ Deposit with the Reserve Bank of India (Securities to be specified)
- ◆ Indian Government Securities
- ◆ State Government Securities
- ◆ British, British Colonial and British Dominion Government Securities
- ◆ Foreign Government Securities
- ◆ Indian Municipal Securities
- ◆ British and Colonial Securities
- ◆ Foreign Securities
- ◆ Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the Indian Government or a State Government
- ◆ Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the

British or any Colonial Government

- ◆ Bonds, Debentures, stocks and other securities whereon interest is guaranteed by any Foreign Government
- ◆ Debentures of any railway in India
- ◆ Debentures of any railway out of India
- ◆ Preference or guaranteed shares of any railway in India
- ◆ Preference or guaranteed shares of any railway out of India
- ◆ Railway Ordinary Stocks (i) in India (ii) out of India
- ◆ Other Debentures and Debenture stock of companies incorporated (i) in India (ii) out of India
- ◆ Other guaranteed and preference stocks and shares of companies incorporated (i) in India (ii) out of India
- ◆ Other ordinary stocks and shares of companies incorporated (i) in India (ii) out of India
- ◆ Holdings in Subsidiary companies

The book value and the market value have to be shown in respect of the investments. Where the market value is ascertained on a basis other than the published quotations, the manner in which such value has been arrived at, is also required to be disclosed.

Appendix IV

Representation Letter for Investments

(Ref. Paragraph 29)

The following is a sample representation letter for investments. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

(Letterhead of Entity)

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Limited as of 19...., and for the year then ended, we confirm to the best of our knowledge and belief, the following representations concerning investments.

1. The current investments as appearing in the balance sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the balance sheet as 'long-term investments'.

III.52 Auditing Pronouncements

2. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.
3. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renounced or allowed to lapse. In no case have they been renounced in favour of third parties without consideration which has been properly accounted for in the books of account.
4. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.
5. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity. There are no charges against the investments of the entity except those appearing in the records of the entity.

Yours faithfully,

(Signature of responsible official of the entity)

GUIDANCE NOTE ON AUDIT OF CASH AND BANK BALANCES*

The following is the text of the Guidance Note on Audit of Cash and Bank Balances issued by the Auditing Practices Committee (APC)¹ of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)² issued by the Institute.

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices*³, issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Cash and Bank Balances, Chapter 6 of the *Statement on Auditing Practices*, titled 'Cash and Bank Balances', shall stand withdrawn.⁴ In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.⁵

INTRODUCTION

3. Cash and bank balances may constitute a significant proportion of the total assets of an entity. An important feature of cash and bank balances which has a significant impact on the related audit procedures is that these assets are highly prone to misappropriation, misapplication and other forms of fraud.

4. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, Audit

* Published in November, 1995 issue of 'The Chartered Accountant.

¹ Now known as the Auditing and Assurance Standards Board (AASB).

² Now known as Engagement Standards.

³ The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

⁴ The special aspects of audit of cash and bank balances in the case of banks are dealt with in the Guidance Note on Audit of Banks (edn. 2008).

⁵ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

III.54 Auditing Pronouncements

Evidence). In carrying out an audit of cash and bank balances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- Existence - that recorded cash and bank balances exist as at the year-end.
- Rights and obligations - that recorded cash and bank balances represent the assets of the entity.
- Completeness - that there are no unrecorded cash and bank balances.

Besides the above, in certain situations, the auditor may also be particularly concerned with the valuation of cash and bank balances, e.g., in the case of foreign currency held by the entity or in the case of bank accounts designated in foreign currencies.

INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to cash and bank balances to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to cash and bank balances.⁶

- (a) segregation of duties relating to authorisation of transactions, handling of cash/issuance of cheques and writing of books of account, and rotation of the duties periodically;
- (b) proper authorisation of cash and banking transactions;
- (c) daily recording of cash transactions;
- (d) safeguards such as restrictive crossing of cheques, use of pre-printed, pre-numbered forms;
- (e) periodic reconciliation of bank balances;
- (f) reconciliation of cash-on-hand with book balance on a daily basis or at other appropriate intervals, including surprise checks by higher authorities;
- (g) safe custody of cash, cheque books, receipt books etc.; and
- (h) cash/fidelity insurance.

VERIFICATION

6. Verification of cash and bank balances may be carried out by employing the procedures described in paragraphs 7-27. It may, however, be emphasised that the nature, timing and extent of substantive procedures to be performed is a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

⁶ The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to cash and bank balances.

VERIFICATION OF CASH BALANCES

7. The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

8. All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be verified at the same time so as to avoid chances of cash balances of one entity being presented as those of another.

9. If IOUs ('I owe you') or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

10. The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

11. If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

12. Where postdated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

VERIFICATION OF BANK BALANCES

13. The auditor should advise the entity to send a letter to all its bankers to, directly confirm the balances to the auditor. The **Appendix** to this Guidance Note gives an illustrative proforma letter of request for confirmation to be used for this purpose. The request for confirmation should also cover dormant accounts as well as accounts closed during the year.

III.56 Auditing Pronouncements

14. The auditor should examine the bank reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statements as at other dates during the year. It should be examined whether (i) cheques issued by the entity but not presented for payment, and (ii) cheques deposited for collection by the entity but not credited in the bank account, have been duly debited/credited in the subsequent period. For this purpose, the bank statements of the relevant period should be examined. If the cheques issued before the end of the year have not been presented within a reasonable time, it is possible that the entity might have prepared the cheques before the end of the year but not delivered them to the parties concerned. In such a case, the auditor should examine that the entity has reversed the relevant entries.

15. Where the auditor finds that post-dated cheques are issued by the entity, he should verify that any cheques pertaining to the subsequent period have not been accounted for as payments during the period under audit.

16. The auditor should pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/write-off.

17. The auditor should be alert to the possibility that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

18. Where a large number of cheques has been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques has subsequently remained unpaid/uncleared, this may indicate an intention of understating creditors/debtors or understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances.

19. The procedures discussed in paragraph 18 should also be considered by the auditor in cases where a large number of cheques is on hand at the date of the balance sheet and a sizable proportion of such cheques has subsequently remained undeposited/uncleared.

20. In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

21. In respect of fixed deposits or any other type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined.

22. Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

23. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

24. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

25. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

EXAMINATION OF VALUATION AND DISCLOSURE

26. The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.⁷ In this regard, the auditor should examine that following items are not included in cash and bank balances:

- (a) Temporary advances.
- (b) Stale or dishonoured cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

27. The auditor should also examine that suitable disclosures as mentioned in paragraphs 20 and 24 above are made in relevant cases.

Appendix

Illustrative Letter of Confirmation – Bank Balances

(Ref. Paragraph 13)

[Letterhead of Entity]

[Name and Address of Bank]

[Date]

Dear Sirs,

Please send directly to our auditors (name and address of the auditors) details of balances as at the close of business on [date] of all our accounts with you as well as details of charges held against such balances, with a copy to us. For your convenience, we enclose in duplicate a form in which details of our balances with you can be filled in. If you find the spaces on the form insufficient to contain all the relevant information, please attach a separate statement.

⁷ For valuation of foreign currency held as cash-in-hand and bank balances designated in foreign currencies, reference may be made to Accounting Standard 11, "Accounting for the Effects of Changes in Foreign Exchange Rates", issued by the Institute of Chartered Accountants of India.

9. *Letters of Credit Open and Outstanding*

In favour of	Amount not utilised	Valid upto
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10. *Guarantees given on behalf of clients*

In favour of	Amount.	Date of expiry
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We certify that the above particulars are full and correct and do not exclude any other obligations of the entity to us.

Yours faithfully,

Name of Bank
Designation of Signatory

GUIDANCE NOTE ON AUDIT OF LIABILITIES*

The following is the text of the Guidance Note on Audit of Liabilities issued by the Auditing Practices Committee (APC)¹ of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)² issued by the Institute.

1. Para 2.1 of the Preface to the Standards on Auditing³ issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”
2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Liabilities, Chapter 9 of the *Statement on Auditing Practices*, titled ‘Liabilities’, shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn⁴.

INTRODUCTION

3. Liabilities are the financial obligations of an enterprise other than owners’ funds.
4. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.
5. Special considerations may apply in the case of audit of liabilities of specialised entities like banks, financial institutions and venture capital funds.
6. Liabilities generally constitute a significant proportion of the total sources of funds of an

* Published in December, 1995 issue of ‘The Chartered Accountant’.

¹ Now known as the Auditing and Assurance Standards Board (AASB).

² Now known as Engagement Standards.

³ The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

⁴ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.

7. An important feature of liabilities which has a significant effect on the related audit procedures is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

8. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions [Standard on Auditing (SA) 500, Audit Evidence]. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

INTERNAL CONTROL EVALUATION

9. The auditor should study and evaluate the system of internal control relating to liabilities to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to liabilities.⁵

(a) *In respect of loans and borrowings (including advances and deposits)*

- (i) As far as possible, the following should be clearly specified:
 - ◆ the borrowing powers and limits;
 - ◆ persons authorised and competent to borrow;
 - ◆ terms of borrowings;
 - ◆ procedure for ensuring compliance with relevant legal requirements/internal regulations.
- (ii) Any variations in the terms of loans and borrowings should be truly approved/ratified in writing by competent authority.
- (iii) Security offered against loans and borrowings should be properly recorded and periodically reviewed.
- (iv) The records and documents should be kept in proper custody and reviewed periodically.
- (v) The system should bring out all cases of non-compliance with terms and conditions including amounts of principal and/or interest which have become overdue.
- (vi) Confirmation of balances should be obtained at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.
- (vii) There should be a proper procedure for year-end valuation of loans and borrowings,

⁵ The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India, which contains, *inter alia*, an illustrative list of internal controls in relation to creditors and borrowings.

III.62 Auditing Pronouncements

especially for those designated in foreign currencies.⁶

(b) *In respect of Trade Creditors*

- (i) The procedure should ensure proper recording of transactions and facilitate the linking of payments with outstandings.
- (ii) The payments made to creditors should be in line with the approved policies of the entity.
- (iii) There should be specific procedures for payments against duplicate invoices or other duplicate records as well as for payments against accounts which have remained unclaimed for quite some time.
- (iv) There should be a procedure for preparation of schedules of trade creditors at periodic intervals; this should be reviewed by a responsible person and necessary action initiated on overdue accounts.
- (v) Statements of account should be called for creditors at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.
- (vi) All adjustments in the creditors' accounts such as those relating to claims for returns, defectives, short receipts of goods, rebates, allowances and commissions etc., should require approval of competent authority. Similarly, any write-back of creditors' balances and escalation claims should be approved by competent authority.
- (vii) There should be appropriate cut-off procedures in relation to transactions affecting the creditor accounts.

(c) *In respect of other current liabilities, trade deposits and provisions*

The internal control procedures as spelt out above for loans and borrowings and creditors broadly apply in relation to these items.

10. In respect of contingent liabilities, the auditor should examine whether the internal control system of the entity provides for a procedure for identifying and estimating such liabilities and for periodic review of the same.

VERIFICATION

11. Verification of liabilities may be carried out by employing the following procedures:

- (a) examination of records;
- (b) direct confirmation procedure;
- (c) examination of disclosure;
- (d) analytical review procedures,
- (e) obtaining management representations.

⁶ Reference may be made in this regard to Accounting Standard 11 (revised 2003), *Effects of Changes in Foreign Exchange Rates*, issued by the Institute of Chartered Accountants of India.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

EXAMINATION OF RECORDS

Loans and Borrowings

12. The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.
13. The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.
14. In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.
15. The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.
16. Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.
17. In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.
18. Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.
19. Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such instalments.
20. The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.
21. The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

Trade Creditors and Other Current Liabilities

22. The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the creditor accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately

III.64 Auditing Pronouncements

before the year-end and verify that the related invoices have been recorded as purchases of the current year.

23. The auditor should check that the total of the creditors' balances agrees with the related control account, if any; the difference, if any, should be examined.

24. The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of creditors/acceptances.

25. The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.

26. While examining schedule of creditors and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:

- (a) long outstanding items;
- (b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;
- (c) liabilities not correlated/adjusted against related advances;
- (d) authorisation and correctness of transfers from one account to another.

Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.

27. In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.

28. The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

Provisions

29. The term 'provision' means amounts retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy. Provisions include those in respect of depreciation or diminution in the value of assets, product warranties, service contracts and guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however, does not deal with provisions for depreciation or diminution in the value of assets.

30. The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.

31. *Provisions for Taxes and Duties:* The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at

the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

32. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date* issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

33. In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.⁷

34. *Provision for Gratuity*: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity.⁸ The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

35. *Provision for Bonus*: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

⁷ Reference may be made in this regard to the Accounting Standard (AS) 22, "Accounting for Taxes on Income" issued by the Institute of Chartered Accountants of India.

⁸ Reference may be made in this regard to Accounting Standard (AS) 15 (Revised in 2005), "Accounting for Employee Benefits", issued by the Institute of Chartered Accountants of India.

36. *Provision for Dividends*: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

37. *Other Provisions*: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

Contingent Liabilities

38. The term 'contingent liabilities' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities.⁹ Some of the instances giving rise to contingent liabilities are:

- (a) law suits, disputes and claims against the entity not acknowledged as debts:
- (b) membership of a company limited by guarantee.

39. The following general procedures may be useful in verifying contingent liabilities.

- (a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.
- (b) Review of contracts, agreements and arrangements.
- (c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.
- (d) Review of terms and conditions of grants and subsidies availed under various schemes.
- (e) Review of records relating to contingent liabilities maintained by the entity.
- (f) Enquiry of, and discussions with, the management and senior officials of the entity.
- (g) Representations from the management.

40. The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

DIRECT CONFIRMATION PROCEDURE

41. The verification of balances by direct communication with creditors is theoretically the best

⁹ Reference may be made in this regard to the Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India.

method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. However, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the creditors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

42. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain creditors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the reason as being the fact that there is a dispute with the particular creditor and the request for confirmation may aggravate sensitive negotiations between the entity and the creditor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the creditor. In such a case, alternative procedures should be applied to creditors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations,

43. The confirmation date, the method of requesting confirmations, and the particular creditors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

44. The creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to seek confirmation from the creditors at a date other than the balance sheet date, he should examine the movements in creditor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that creditor balances stated in the balance sheet are not materially misstated.

45. The form of requesting confirmation from the creditors may be either (a) the 'positive' form of request, wherein the creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request, wherein the creditor is requested to respond only if he disagrees with the balance shown.

46. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in **Appendix I** to this Guidance Note.

III.68 Auditing Pronouncements

47. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the creditors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the creditor balances. An illustrative negative form of request letter is given in **Appendix II** to this Guidance Note.

48. In many situations, it may be appropriate to use the positive form for creditors with large balances and the negative form for creditors with small balances.

49. Where the number of creditors is small, all of them may be circularised, but if the creditors are numerous, this may be done on a sample basis. The sample list of creditors to be circularised, in order to be meaningful, should be based on a complete list of all creditor accounts. While selecting the creditors to be circularised, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and supplier accounts with debit balances. In addition, the auditor should select accounts in respect of which balances have been written back to the profit and loss account. In such cases, the auditor may decide that the balance as per the books of the entity may not be stated in the request letter sent to the creditors concerned; instead, the creditors may be asked to intimate the balance as per their records. The auditor may also consider including in his sample some of the accounts which have been fully squared up. The nature of the entity's business and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the creditors as a whole.

50. In appropriate cases, the creditor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the usual trade terms.

51. The method of selection of the creditors to be circularised should not be revealed to the entity until the trial balance of the creditors' ledger is handed over to the auditor. A list of creditors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

52. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those creditors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant creditors from whom he receives no replies despite reminders, with intimation to the entity. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

53. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of creditors taken as a whole.

EXAMINATION OF DISCLOSURE

54. The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

55. In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

56. The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

57. The auditor should examine that the following have been disclosed in respect of contingent liabilities:

- (a) nature of each contingent liability;
- (b) the uncertainties which may affect the future outcome;
- (c) an estimate of the financial effect or a statement that such estimate cannot be made.

ANALYTICAL REVIEW PROCEDURES

58. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions:

- (a) comparison of closing balances of loans and borrowings, creditors, etc., with the corresponding figures for the previous year;
- (b) comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;
- (c) comparison of actual closing balances of loans and borrowings, creditors, etc., with the corresponding budgeted figures, if available;
- (d) comparison of current year's aging schedule of creditors with the corresponding figures for the previous year;
- (e) comparison of significant ratios relating to loans and borrowings, creditors, etc., with the similar ratios for other firms in the same industry, if available;
- (f) comparison of significant ratios relating to loans and borrowings, creditors, etc. with the

III.70 Auditing Pronouncements

industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor

Special Considerations in the Case of a Company

59. In addition to the procedures described above, the auditor should also employ the following procedures in the case of audit of a company.

- (a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1(d) of the Companies Act, 1956 are complied with.
- (b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.
- (c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are *prime facie* prejudicial to the interest of the company.¹⁰
- (d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.
- (e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed thereunder regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.
- (f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax, sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.¹¹
- (g) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they

¹⁰ Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

¹¹ Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003 (Revised 2005)* issued by the Institute of Chartered Accountants of India.

are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

MANAGEMENT REPRESENTATIONS

60. The auditor should obtain from the management of the entity a written statement that all known liabilities have been recorded in the books and that all contingent liabilities have been properly disclosed. While such a representation letter serves as a formal acknowledgment of the management's responsibilities for proper accounting and disclosure of the relevant items, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial statement. A sample management representation letter regarding liabilities and contingent liabilities is given in **Appendix III** to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

61. The auditor should maintain adequate working papers regarding audit of liabilities and contingent liabilities. Among others, he should maintain on his audit file, confirmations received as well as any undelivered letters of request for confirmation. The management representation letter contingent liabilities and contingent liabilities should also be maintained on the audit file.

Appendix I

Illustrative Letter of Confirmation to be Sent to Creditors - Positive Form

[Ref. paragraph 46]

[Letterhead of Entity]

[Name and Address of Creditor]

[Date]

Dear Sir,

III.72 Auditing Pronouncements

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs. _____ due by us to you as on _____ as shown by our books, is correct. The details of the balance are as under:¹²

Invoice No.	Date	Order Reference	Amount
		Total	_____
		Less: Payments made/other debits	_____
		Net amount due to us (Rs.)	_____

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

Kindly return this form in its entirety.

Yours faithfully,

(Signature of responsible official of the entity)

(Do not perforate the form at this point)

[Name and Address of Entity]

(A) We confirm that the above stated amount is correct as at _____

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at _____ as per our records are as below:

Invoice No.	Date	Order Reference	Amount
		Total	_____

¹² In case the list of invoices forming the balance is too large, these details may not be given.

	Less: Payments made/other debits _____
	Net amount due to us (Rs.) _____
Date _____	

(Signature of creditor/responsible official)

Appendix II**Illustrative Letter of Confirmation to be Sent to Creditors - Negative Form***[Ref. paragraph 47]*

[Letterhead of Entity]

[Date]

[Name and Address of Creditor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of Rs. _____ due by us to you as on _____ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:¹³

Invoice No.	Date	Order Reference	Amount
Total			_____
Less: Payments made/other debits			_____
Net amount due by us (Rs.)			_____

If you do not notify our auditors of any difference within ten days of the date of this letter, it will be presumed that the balance stated above is correct.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

¹³ In case the list of invoices forming the balance is too large, these details may not be given

**Illustrative Representation Letter for
Liabilities and Contingent Liabilities**

[Ref. paragraph 60]

The following is a sample representation letter for liabilities and contingent liabilities. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of, 19....., and for the year then ended, we confirm, to the best of our knowledge and belief, the following representations:

1. We have recorded all known liabilities in the financial statements.
2. We have disclosed in notes to the financial statements all guarantees that we have given to third parties and all other contingent liabilities.
3. Contingent liabilities disclosed in the notes to the financial statements do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.
4. Provisions have been made in the accounts for all known losses and claims of material amounts.

Yours faithfully,

(Signature of responsible official of the entity)

GUIDANCE NOTE ON AUDIT OF REVENUE*

*The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)+ issued by the Institute.*

1. Para 2.1 of the 'Preface to the Statements on Standard Auditing Practices'¹, issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."
2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Revenue, paragraph 11.1 of Chapter 11 of the Statement on Auditing Practices, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire Statement of Auditing Practices shall be withdrawn.²

INTRODUCTION

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term 'revenue' covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. For example, in an agency relationship, revenue from the view point of the agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.

* Published in May, 1997 issue of 'The Chartered Accountant'.

** Now known as the Auditing and Assurance Standards Board (AASB).

+ Now known as the Engagement Standards.

¹ The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

² Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

III.76 Auditing Pronouncements

4. This Guidance Note deals with the audit of the following types of revenue (dealt with in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India) arising in the course of the ordinary activities of an entity:

- ◆ Sale of goods.
- ◆ Rendering of services.
- ◆ Use by others of entity resources yielding interest, royalties and dividends.

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out an audit of revenue, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Occurrence –	that recorded revenue arose from transactions which took place during the relevant period and pertain to the entity.
Completeness –	that there is no unrecorded revenue.
Measurement –	that revenue is recorded in the proper amounts and is allocated to the proper period.
Presentation and Disclosure –	that revenue is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

INTERNAL CONTROL EVALUATION

6. The auditor should study and evaluate the system of internal control relating to revenue, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to revenue:³

- (a) The systems and procedures relating to generation of revenue including authority to fix prices, offer discounts and other terms of sale.
- (b) Accounting procedures relating to recognition of revenue.
- (c) Existence of periodic reports on actual performance vis-à-vis budgets.

VERIFICATION

7. Verification of revenue may be carried out by employing the following procedures:

- (a) examination of records;
- (b) analytical review procedures.

³ The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative list of internal controls in relation to sales.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

EXAMINATION OF RECORDS

8. The auditor should examine whether the basis of recognition of revenue by the entity is in accordance with the recognised accounting principles as laid down in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India.

9. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to sales and sale returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the despatch documents (such as railway receipts) pertaining to a few days immediately before the year-end and verify that the related sale invoices have been recorded as sales of the current year.

10. The auditor should examine selected entries in the sales journal with reference to the related sale invoices, dispatch documents and other supporting documents such as the customers' orders, credit approval notes, etc. He should compare the actual price charged with the authorised price lists or with the authorisation by the appropriate official of the entity, as the case may be. The auditor should also trace the selected entries to the customers' account.

11. The auditor should also examine selected despatch documents with reference to related sale invoices and the sales journal.

12. The auditor should examine selected entries in the sales return journal with reference to the receiving reports in respect of goods returned, credit notes and entries in the customers' accounts. Similarly, the auditor should examine selected credit notes with reference to entries in the sales return journal, receiving reports in respect of goods returned, and entries in the customers' accounts.

13. In respect of goods sent on approval, the auditor should particularly examine that revenue in respect of such goods is not recognised until (a) the goods have been formally accepted by the buyer, or (b) the buyer has done an act adopting the transaction, or (c) the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue

III.78 Auditing Pronouncements

should not be recognised until the related goods are sold to a third party.⁴

15. Where the consideration is receivable in installments and includes an element of interest, the auditor should examine that the revenue attributable to the sale excludes the interest element.

16. In respect of export sales, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic sales.

- (a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*⁵.
- (b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.⁶

17. In respect of revenue arising from services rendered (i.e., in the form of fees, commission, brokerage, etc.), the auditor should examine the related agreements and other documents. Similarly, in respect of revenue in the form of interest, dividends and royalties, the auditor should examine the related documents such as loan documents, lease agreements, etc. The auditor may also seek confirmatory certificates from the parties concerned.

18. The auditor should also verify realisations subsequent to the date of the balance sheet to identify items of unrecorded revenue.

EXAMINATION OF PRESENTATION AND DISCLOSURE

19. The auditor should satisfy himself that the revenue has been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

ANALYTICAL PROCEDURES

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to revenue:

- (a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.
- (b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.
- (c) Comparison of ratio of sales returns to sales for the current year with the corresponding

⁴ Reference may be made to AS 1, *Disclosure of Accounting Policies*, for discussion on the concept of "substance over form".

⁵ This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is "Effects of Changes in Foreign Exchange Rates".

⁶ Reference may be made in this regard to SA 580, "Representations by Management".

figures for previous years.

- (d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.
- (e) Comparison of ratio of excise duty/sales tax/export incentives to sales for the current year with the corresponding figures for previous years.
- (f) Comparison, product-wise and location-wise, of quantity sold during the year with the corresponding figures for previous years.
- (g) Product-wise reconciliation of quantity sold during the year with opening stock, purchases/production and closing stock.
- (h) Comparison of dividend/interest/royalty for the current year with the corresponding figures for previous years.
- (i) Comparison of ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. Similarly, he may relate the wage payments to the quantum of output, and so on.

It may be clarified that the foregoing is only an illustrative list of analytical procedures, which an auditor may employ in carrying out an audit of revenue. The exact nature of analytical procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

SPECIAL CONSIDERATIONS IN THE CASE OF A COMPANY

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the [Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the price at which transactions for similar goods or services have been made with other parties.^{7]}

DOCUMENTATION

22. The auditor should maintain adequate working papers regarding audit of revenue.

⁷ Reference may be made in this regard to Statement on Companies (Auditor's Report) Order, 2003 (Revised 2005).

GUIDANCE NOTE ON AUDIT OF EXPENSES*

Para 2.1 of the "Preface to the Statements on Standard Auditing Practices"¹ issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs)" so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

The Auditing Practices Committee^{***} has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Expenses, paragraphs 11.2-11.8 of Chapter 11 of the *Statement on Auditing Practices*, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.²

The following is the text of the Guidance Note on "Audit of Expenses" issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices issued by the Institute.

INTRODUCTION

1. An expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. The expression "cost" means the amount of expenditure incurred on or attributable to a specified article, product or activity.

2. Expenses are recognised by the following approaches:

(a) *Identification with revenue transactions*

^{*} Published in November, 2001 issue of 'The Chartered Accountant'.

¹ The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

^{**} Now known as Engagement Standards.

^{***} Now known as Auditing and Assurance Standards Board.

² Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

Costs directly associated with the revenue recognised during the relevant period are considered as expenses and are charged to income for the period.

(b) *Identification with a period of time*

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time.³ Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, travelling, depreciation on office building, normal interest, etc. Similarly, the costs, the benefits of which, do not clearly extend beyond the accounting period are also charged as expenses.

3. The following features of expenses affect the nature, timing and extent of the related audit procedures:

- (a) In the case of most items of expenses, documentary evidence originating from third parties is available.
- (b) The nature and relative significance of various items of expenses usually differ from one enterprise to another, depending primarily on the nature of operations carried out by them. For example, in the case of most manufacturing enterprises, the principal items of expenses would include the cost of raw materials consumed, labour cost and other conversion costs. On the other hand, in the case of a trading enterprise, the principal items of expenses would generally be the cost of goods sold. In the case of an enterprise supplying, providing, maintaining and operating any services, the principal items of expense would include personnel and professional expenses, office maintenance, etc.
- (c) The amount of some expenses has a logical relationship with certain other financial statement items while the amount of some other expenses does not have such a relationship. For example, in an enterprise where the production process is standardised, the consumption of raw materials (and, therefore, the cost of raw materials consumed) has a logical relationship with the quantum of output. Similarly, the proportion of various constituents of cost of production is expected to remain more or less constant in the absence of known conditions to the contrary. Likewise, proportion of the amount of interest for a period to the amount of loans outstanding during the period is expected to vary within certain specific limits. On the other hand, the expenditure on research and development often has little relationship with other items in the financial statements.
- (d) The amount of some items of expenses (e.g., gratuity, taxes, bonus, etc.) is significantly affected by applicable laws.

4. In an audit, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see SA 500, *Audit Evidence*). In carrying out an audit of expenses, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

³ Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.

III.82 Auditing Pronouncements

Occurrence	that recorded expenses arose from transactions or events that place during the relevant period and pertain to the entity.
Completeness	that there are no unrecorded expenses.
Measurement	that expenses are recorded in the proper amounts and are allocated to the proper period.
Presentation and Disclosure	that expenses are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

5. In view of the divergence in the nature of expenses incurred by different enterprises, it is not possible to describe the audit procedures applicable in carrying out an audit of expenses in all situations. This Guidance Note provides guidance on procedures to be employed in carrying out an audit of expenses which would be applicable in the case of most enterprises. It is recognised, however, that audit procedures different from or additional to those described in this Guidance Note may be necessary in a particular case, depending upon its specific facts and circumstances.

INTERNAL CONTROL EVALUATION

6. The auditor should study and evaluate the system of internal control relating to expenses, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to expenses:⁴

- (a) The systems and procedures relating to incurring of expenses including authorisation procedures.
- (b) Accounting procedures relating to recognition of expenses.
- (c) Existence of periodic reports on actual performance *vis a vis* budgets and internal management reports, if any.

VERIFICATION

7. Verification of expenses may be carried out by employing the procedures, *viz.*, (a) examination of records; and (b) analytical procedures. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls. The auditor should examine whether the basis of recognition of expenses by the entity is in accordance with the recognised accounting principles.

⁴The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to petty cash, cash and bank payments, salaries and wages and purchases.

(a) Examination of Records

8. Examination of records and documents is one of the most important techniques of auditing. An auditor has to examine a large number of documents in the course of an audit since most transactions are supported only by documentary evidence. The accounting systems of business enterprises are so designed that documentary evidence is created in respect of each transaction. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and other assertions with regard to various expenses incurred by the entity. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

(b) Analytical Procedures

9. The auditor should conduct analytical procedures which involve analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.⁵

10. The following paragraphs describe the audit procedures applicable in respect of various items of expenses.

GOODS AND RAW MATERIALS CONSUMED

11. The auditor's examination of the cost of goods, stores and materials consumed during the year would involve, *inter alia*, examination of purchases of goods and materials made during the year as well as of purchase returns and of opening and closing inventories.

PURCHASES AND PURCHASE RETURNS

12. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to purchases and purchase returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the selected receipt documents (such as goods received notes) pertaining to a few days immediately before the year-end and verify that the related purchase invoices have been recorded as purchases of the current year. The auditor should pay particular attention to the cut-off procedures relating to purchases, both indigenous and imported, to determine whether these procedures ensure recognition of purchases at the time the significant risks and rewards of ownership of the related goods pass on to the entity.

13. The auditor should examine selected entries in the purchase journal with reference to the related purchase invoices, receipt records and other supporting documents such as the purchase orders. The auditor should also trace the selected entries to the suppliers' account.

14. While examining purchase invoices, the auditor should examine whether subsidies, rebates, duty drawbacks or other similar items have been properly accounted for. As per AS 2, costs of purchase consist of the purchase price including duties and taxes (other than those

⁵ Refer to Standard on Auditing (SA) 520, "Analytical Procedures".

III.84 Auditing Pronouncements

subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

15. The auditor should also examine selected receipt records with reference to related purchase invoices and the purchase journal.

16. The auditor should examine selected entries of purchase returns with reference to the goods returned notes, debit notes and entries in the suppliers' accounts. Similarly, the auditor should examine selected debit notes with reference to purchase returns, goods returned notes, and entries in the suppliers' accounts.

17. In case of transactions between related parties, the auditor should pay special attention to nature and description of such transactions.⁶

18. The auditor should obtain a representation from the management to the effect that the entity has complied with the legal and regulatory requirements, if any. When the auditor becomes aware of non-compliance, the auditor should obtain sufficient information to evaluate the possible effect in the financial statements. The auditor should also consider communication/reporting of non-compliance with the management including audit committee, users of financial statements and to regulatory authorities, as may be appropriate.⁷

19. In respect of imports, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic purchases.

- (a) Besides examining the usual documents relating to purchases, the auditor should also examine such documents as bill of lading, custom documents, etc., which are specific to import transactions.
- (b) The auditor should pay special attention to the terms of import relating to the incidence of charges like insurance and freight, i.e., whether the imports are on C.I.F. basis, or F.O.B. basis, or some other basis.
- (c) The auditor should examine that imports for which consideration is payable in a foreign currency are recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*.

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to purchases.

- (a) Comparison, item-wise and location-wise, both quantity and value, of purchases for the current year/period with the corresponding figures for previous years/periods.
- (b) Comparison of ratio of gross margin to sales for the current year/period with the corresponding figures for previous years/periods.

⁶ Refer to Accounting Standard (AS) 18, "Related Party Disclosures".

⁷ Refer to Standard on Auditing (SA) 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

- (c) Comparison of ratio of purchase returns to purchases for the current year/period with the corresponding figures for previous years/periods.
- (d) Product-wise reconciliation of quantity sold during the year/period with opening stock, purchases/production and closing stock.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. In case segment information is available, the above procedures may be carried out for each segment.

21. The auditor should also verify payments subsequent to the date of the balance sheet to identify any purchases which have not been recorded in the books of account.

Wages and Salaries

22. The auditor should examine the entries in the payroll/wage sheets with reference to relevant records, e.g., employee's records maintained by the personnel department showing details of pay such as basic pay, allowances, annual increments, leaves availed, etc. Special attention may also be paid by auditor in respect of new employees joining the entity during the year. Similarly, the payroll may also be examined with reference to the time records/attendance records and leave records maintained by the personnel department. The deductions made in respect of income-tax, provident fund, Employees' State Insurance (ESI), welfare schemes, health schemes, etc., may be examined with reference to the returns submitted to the authorities concerned and the receipts/acknowledgments issued by such authorities.

23. The auditor should examine whether any legal, regulatory or contractual requirements having a bearing on the rate or amount of wages and salaries have been complied with. Similar considerations would also apply to payments made to a contractor for hire of labour. Such requirements would include, *inter alia*, the provisions of the Minimum Wages Act, 1948, agreement with the employees, award of competent authority and judicial rulings.

24. In the case of senior management officials, the auditor should pay particular attention to determining whether the salaries payable are as per the terms of contract with the employees concerned. Special requirements of terms of contract such as granting stock options (as per schemes formulated by SEBI), availing leave encashment, total amount payable annually including ex-gratia, etc., should be specifically looked into.

25. In the case of casual labour, besides carrying out the other audit procedures, the auditor should specifically examine the sanction of the competent authority for employment of such labour and ascertain whether such employees are retained as per the time rate or piece-rate basis. In appropriate cases, the auditor may pay a surprise visit to the sites where the casual labour is employed to assess the correctness of the attendance records maintained in respect of such labour. In cases where complete outsourcing of labour has been given to an outside agency, the terms of agreement and compliance thereof would be examined.

III.86 Auditing Pronouncements

26. The auditor should obtain a list of employees who have retired or otherwise left the services of the entity during the period under audit and examine that they have not been included in the payroll.

27. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to wages and salaries:

- (a) comparison of wage bill for the year/period with the wage bill of previous years/periods;
- (b) comparison of the monthly wages and salaries of a month with other months during the year/period and with the corresponding month of the previous years/periods;
- (c) comparison of the wage bill for each department/unit for the current year/period with the corresponding figures for previous years/periods;
- (d) comparison of the ratios of wages and salaries to sales for the current year/period with the corresponding figures for the previous years/periods;
- (e) comparison of the ratio of wages and salaries to cost of production for the current year/period with the corresponding figures for previous years/periods;
- (f) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the corresponding figures for previous years/periods;
- (g) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing provident fund;
- (h) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the corresponding figure for previous years/periods;
- (i) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing the ESI.

Bonus

28. In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965, and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

Retirement Benefits

29. The auditor should examine whether the entity is liable to pay any retirement benefits to its employees such as provident fund, superannuation/pension, gratuity, etc., whether in pursuance of requirements of any law and/or in terms of agreement with the employees⁸. If so, the auditor should examine whether the amount payable has been computed in accordance

⁸ Attention is invited in this regard to Accounting Standard (AS) 15, "Accounting for Employees Benefits".

with the relevant legal and/or contractual requirements. In respect of gratuity/pension, the auditor should specifically examine whether the provision for accruing gratuity/pension liability has been made by the entity. The auditor should examine the adequacy of provision with reference to the actuarial certificate obtained by the entity⁹. In case the entity has not obtained such an actuarial certificate, the auditor should examine that the method followed by it, say, group gratuity insurance scheme taken by the entity, for calculating the accrued liability for gratuity is rational.

Other Conversion Costs

30. The auditor should verify the other conversion costs (such as power and fuel, processing charges, etc.) with reference to the supporting documents and related agreements. In case the material is sent outside to third parties for processing, necessary charges including existence of materials, wastage, etc., need to be ascertained and accounted for. In addition, the auditor may also compare the amount of expense on a particular item with the corresponding figure for previous years. Similarly, he may work out the ratios of different items of conversion costs to total cost of production for the current year and compare the same with the corresponding figures for previous years.

Establishment and General Administrative Expenses

31. The auditor should verify establishment expenses and general administrative expenses such as insurance, rent, rates, conveyance, travelling, telephone, entertainment, printing and stationery, general expenses, etc., with reference to the sanction of the competent authority, the supporting documents, related agreements and the rules and regulations followed by the entity. The auditor may also compare the amounts of these expenses with the corresponding figures for previous years. Similarly, he may work out the ratios of different items of expenses to sales for the current year and compare the same with the corresponding figures for previous years.

Interest and Financial charges

32. The auditor should verify the amount of interest expense for the year with reference to the terms and conditions of relevant agreements. The auditor may also work out the ratio of interest expense for the year to average interest-bearing loans and advances outstanding during the year and compare it with the corresponding figure for previous years and reconcile the same. The auditor should particularly examine that interest as well as other financing costs such as commitment fees on funds borrowed for a qualifying asset included in the gross book value of the asset to which they relate and have not been charged to the Profit and Loss Account of the period in which they are incurred¹⁰. If the entity has paid any penal interest, it should also be examined. Such interest should be disclosed as part of normal interest. The auditor should consider, having regard to the materiality, whether it requires separate disclosure.

⁹Attention is also invited in this regard to Standard on Auditing (SA) 620, "Using the Work of an Expert".

¹⁰ Attention is invited in this regard to Accounting Standard (AS) 16, "Borrowing Costs".

DEPRECIATION

33. The auditor should check the calculation of depreciation. The total depreciation arrived at should be compared with that of previous years to identify reasons for variations. The auditor should particularly examine whether the depreciation charge having regard to rate of depreciation and method of depreciation followed consistently is adequate keeping in view the generally accepted bases of accounting for depreciation¹¹. Alternatively, the auditor may consider qualifying his report. In case, assets have been revalued by entity during the year, the auditor should ensure that the depreciation has been computed properly.

RESEARCH AND DEVELOPMENT EXPENSES

34. The auditor should verify various items of expenses incurred on research and development with reference to supporting documents and related agreements. For example, the cost of materials consumed for research and development may be verified with reference to such documents as purchase invoices, goods received notes, records relating to issue of materials, etc. The auditor should particularly examine whether the accounting policy followed by the entity regarding treatment of research and development costs is in accordance with Accounting Standard (AS) 8, "Accounting for Research and Development".

35. The auditor should examine whether the deferral meets the appropriate legal requirements, if any. If an accounting policy for deferral of research and developments is adopted, it should be applied to all such projects which meet the criteria laid down for deferral under AS 8. The auditor should examine whether the criteria laid down in AS 8 which previously justified the deferral of certain research and development costs no longer apply, the unamortised balance has been charged as an expense of the year. Similarly, the auditor should examine that where the criteria for deferral continue to be met but the amount of unamortised balance of the deferred research and development costs and other relevant costs exceed the expected future revenues/benefits related thereto, such excess has been charged as an expense immediately.

REPAIRS AND MAINTENANCE

36. The auditor should scrutinise the repairs and maintenance account to ascertain that new fixed assets and substantial improvements to existing assets have not been included in repairs and maintenance. The auditor should exercise special care particularly in case large amounts charged to the Profit and Loss Account.

CONTINGENCIES

37. In respect of product warranties, service contracts, performance warranties, etc., the auditor should examine whether provisions have been made in accordance with Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date". The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements and the assessment based on his past experience.

¹¹ Attention is also drawn to Accounting Standard (AS) 6, "Depreciation Accounting".

TAXES ON INCOME

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements¹². The tax expense for the period which comprises current tax and deferred tax is to be included in the determination of net profit or loss for the period under audit. In case of companies attracting minimum alternate tax, it has to be ensured that proper provision has been considered in the accounts. The auditor should examine that the deferred taxes have been recognised for all timing differences subject to consideration of prudence in respect of deferred tax assets as set out in Accounting Standard (AS) 22, *Accounting for Taxes on Income*. If there is a material departure from the provisions of AS 22, the auditor should qualify his report.

39. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether adjustment is required in the financial statements.

40. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under relevant provisions of the Income-tax Act, 1961. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard 4, *Contingencies and Events Occurring After the Balance Sheet Date*). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

41. The auditor should obtain from the management, a statement showing the status of pending tax matters. He should examine the statements to assess the adequacy of provisions made in respect of those matters in the context of their current status.

SPECIAL CONSIDERATIONS IN THE CASE OF A COMPANY

42. *In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. Some of the illustrative procedures specifically applicable in the case of audit of a company are described below. It may be clarified that the following is not an exhaustive list of additional procedures to be carried out in the case of audit of expenses in the case of a company.*

¹² Attention is drawn to Accounting Standard (AS) 22, "Accounting for Taxes on Income".

III.90 Auditing Pronouncements

- (a) The auditor should examine whether the managerial remuneration paid or payable by the company is within the limits laid down under section 198 and Schedule XIII to the Companies Act, 1956. The auditor should also examine whether the remuneration paid or payable to the directors of the company, including any managing or whole-time director, has been determined by the Articles of Association of the company or by a resolution of the company passed in a general meeting. The auditor should also examine whether the remuneration of directors complies with the provisions of section 309 of the Companies Act, 1956. The auditor should further examine whether the computation of net profit for purposes of managerial remuneration is in accordance with sections 349 and 350 of the Companies Act, 1956.
- (b) The auditor should examine whether the contributions, if any, made by the company to charitable and other funds not directly relating to the business of the company or the welfare of its employees comply with the provisions of section 293 of the Companies Act, 1956. According to this section, the board of directors of a public company cannot, except with the consent of the company in general meeting, contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed Rs.50,000 or 5 per cent of the average net profits of the company as determined in accordance with the provisions of section 349 and section 350 during the three financial years immediately preceding, whichever is greater. The auditor should examine whether the Memorandum of Association of the company empowers it to make contributions to charitable or other funds not directly relating to the business of the company or the welfare of its employees. If the objects clause in the Memorandum does not contain such authority, the company has no power to make such contributions.

The auditor should ask the management to prepare a schedule of contributions to various funds covered by section 293 made during the year, giving the names of the institutions to which contributions have been made, the amounts paid and the dates on which the contributions were approved by the board of directors. He should also ask the management to prepare a computation showing the limits of permissible contributions which can be made under this section.

- (c) The auditor should examine whether political contributions made by the company are within the limit prescribed in section 293A of the Companies Act, 1956.¹³ Where the limit laid down under section 293A is adhered to and the facts are properly disclosed, the auditor has no further duty. Where, however, the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the facts therein. Where the auditor has genuine doubt regarding the applicability of the Section, he should ensure that the fact is properly disclosed in his audit report.

Where the auditor is satisfied that political contributions have been made in excess of the limit prescribed in section 293A, he should bring this to the attention of the shareholders

¹³ Reference may be made in this regard to the Guidance Note on Section 293A of the Companies Act, 1956 and the Auditor.

by qualifying his audit report and making a mention of the excess amount involved, if ascertainable.

The auditor should obtain a certificate from company's board of directors to the effect that all amounts of contributions to political parties or for any political purpose to any person falling under the provisions of section 293A have been brought into the books of account of the company and that no amounts of such nature other than those so included in the books have been paid/given, directly or indirectly.

- (d) The auditor should examine whether the contribution, if any, to the National Defence Fund or any other fund approved by the Central Government for the purpose of national defence complies with the provisions of section 293B of the Companies Act, 1956. This section empowers the board of directors to make such contributions. It may be noted that unlike the contributions to charitable or other funds not directly relating to the business of the company or to the welfare of its employees, contributions to National Defence Fund (or other similar funds) can be made by a company even where the Memorandum of Association of the company does not specifically empower it in this regard. The auditor should examine whether the total amount or amounts contributed by the company to the National Defence Fund (or other similar funds) during the year have been suitably disclosed in the profit and loss account.
- (e) In respect of payments to sole-selling agents, the auditor should examine whether the provisions of sections 294, 294A and 294AA have been complied with.
- (f) The auditor should examine whether the provisions of section 297 have been complied with in appropriate cases. He should also examine compliance with the terms and conditions, if any, stipulated by the Central Government in its approval under the proviso to sub-section (1) of section 297.
- (g) In case any partner or relative of a director of the company, any firm in which such director, or relative of such director, is a partner, any private company of which such director is a director or member, or any director, or manager of such a private company, holds any office or place of profit under the company or under any subsidiary of the company, the auditor should examine whether the provisions of section 314 have been complied with.
- (h) The auditor should examine whether any personal expenses have been charged to revenue account.
- (i) The auditor should examine whether the transaction of purchase of goods and materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956, as aggregating during the year to Rs.50,000[@] (Rupees Fifty Thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such

[@] This limit has been enhanced to Rs. five lacs by the Companies (Auditor's Report) Order, 2003.

III.92 Auditing Pronouncements

goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.¹⁴

- (j) The auditor should examine whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at the last day of financial year concerned, for a period of more than six months from the date they became payable have been reported under MAOCARO, 1988@@.

EXAMINATION OF PRESENTATION AND DISCLOSURE

43. The auditor should satisfy himself that the expenses have been properly classified and disclosed in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

MANAGEMENT REPRESENTATION

44. The auditor should consider obtaining a management representation on expenses charged to the statement of profit or loss when other sufficient appropriate audit evidence cannot reasonably be expected to exist.¹⁵

DOCUMENTATION

45. The auditor should maintain adequate working papers regarding audit of expenses.¹⁶

¹⁴ Reference may be made in this regard to the Statement on the Companies (Auditor's Report) Order, 2003 (Revised in 2005).

@@ Replaced by the Companies (Auditor's Report) Order, 2003.

¹⁵ Reference may be made in this regard to Standard on Auditing (SA) 580, "Representation by Management".

¹⁶ Reference may be made in this regard to Standard on Auditing (SA) 230, "Documentation".

GUIDANCE NOTE ON SECTION 227(3)(e) AND (f) OF THE COMPANIES ACT, 1956 [REVISED]*

INTRODUCTION

1. Section 227 of the Companies Act, 1956 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 227(1A) of the Act requires the auditor to make certain specific enquiries during the course of audit. Section 227(2) of the Act requires the auditor, *inter alia*, to give his report to the members of company on the accounts examined by him, and on every balance sheet and profit and loss account and every document declared to be a part of or annexed to such balance sheet or profit and loss account which are laid before the company in a general meeting during the tenure of the auditor's office. Sub-section (3) of section 227 of the Act also lays down certain matters necessarily required to be reported upon by the auditor in his report. The auditor is also required to include a statement on the matters specified in the Companies (Auditor's Report) Order, 2003 (Revised 2005) (hereinafter referred to as "CARO, 2003"), issued under section 227(4A) of the Act. Sub-section (3) of section 227 of Act provides as follows:

- "(3) The auditor's report shall also state -
- (a) whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit;
 - (b) whether, in his opinion, proper books of account, as required by law, have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
 - (bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;
 - (c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;
 - (d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;
 - (e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;

* Issued in March, 2001.

III.94 Auditing Pronouncements

- (f) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274;
 - (g) whether the cess payable under section 441A has been paid and if not, the details of the amount of cess not paid.¹
2. In terms of reporting requirements under sub-sections (2) and (3) of section 227 of the Act, matters on which the auditor has to report upon, can be broadly divided into two categories as under:
- (i) statements of fact; and
 - (ii) opinions.
3. The statements of fact are:
- (i) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;
 - (ii) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditors has been forwarded to him as required by section 228(3)(c) and how he has dealt with the same in preparing the auditor's report;
 - (iii) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;
 - (iv) whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274; and
 - (v) whether the cess payable under section 441A has been paid and if not, the details of the amount of cess not paid.
4. The opinions which the auditor is required to express are:
- (i) whether proper books of account as required by law have been kept by the company so far as it appears from the examination of the books and proper returns adequate for the purposes of the audit have been received from branches not visited by him;
 - (ii) whether the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;
 - (iii) whether the accounts give the information required by the Act in the manner so required; and
 - (iv) whether the accounts give a true and fair view, in the case of the balance sheet of the state of the company's affairs, and in the case of the profit and loss account, of the profit or loss for the year.

SCOPE OF THE GUIDANCE NOTE

5. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (e) and (f) of sub-section (3) of section 227 of the Act. Clause (e) of the

¹ Inserted by the Companies (Second Amendment) Act, 2002.

said sub-section creates a requirement for the auditor to consider whether any matter leading to the modification of the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company. It may be noted that the matters that lead to modification in the auditor's report on financial statements are an emphasis of matter paragraph, qualification, situation giving rise to limitation on scope and disagreement with the management². If the matter leading to the modification of the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to highlight such matter in **thick** type or in *italics*. Under clause (f) of sub-section (3) of section 227 of the Act, the auditor is required to state whether any director of the company is disqualified from being appointed a director of a company in terms of clause (g) of sub-section (1) of section 274 of the Act.

REPORTING UNDER SECTION 227(3)(E) OF THE ACT

6. The relevant extracts of section 227(3)(e) of the Act are reproduced below:

“3. *The auditor's report shall also state –*

.....
(e) in thick type or in italics, the observations or comments of the auditors, which have any adverse effect on the functioning of the company”.

7. Clause (e) requires the auditor to highlight "in thick type or in italics, the observations or comments which have any adverse effect on the functioning of the company". An auditor's report may contain matters leading to modifications in the auditor's report on financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words "observations" or "comments" as appearing in clause (e) of section 227(3) are construed to have the same meaning as referring to "emphasis of matter paragraphs, qualifications, situations giving rise to limitation on scope, disagreements with the management leading to modification in the auditors report". Therefore, only such "observations" or "comments" which have an adverse effect on the functioning of the company are required to be stated in thick type or in italics. For the sake of clarity, it may be noted that neither the auditor's observations nor the comments made by him have any adverse effect on the functioning of a company. Instead, these observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.

8. The Act does not specify the meaning of the phrase 'adverse effect on the functioning of the company'. The expression may be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, etc. However, such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit stipulated under the Act. A more logical and harmonious interpretation is that the amendment

² Reference may be made to paragraphs 31 through 47 of Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements."

does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.

9. The scope of the audit and auditor's role remains as contemplated under the Engagement Standards and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200A, "Objective and Scope of the Audit of Financial Statements" specifies, "the auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise". It also states, "the auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factors, absolute certainty in auditing is rarely attainable". Further, it also clarifies that "in forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery".

10. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (e) in sub-section (3) of section 227 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate subject matters leading to modification of the audit report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters, which in the opinion of the auditor, deal with matters that have an adverse effect on the functioning of the company should be given in **thick** type or in *italics*. Conversely, such qualifications or adverse remarks of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be given in **thick** type or in *italics*. Examples of qualifications or adverse comments which have an adverse effect on the functioning of the company include a situation where the going concern assumption is considered inappropriate or there exists any item having a significant impact on the current financial results of the company and which might also have a material effect on the future results of the entity, e.g., non-determination of obsolete stocks / bad debts, significant impairment of the assets, etc.

11. As far as inquiries under section 227(1A) are concerned, the auditor is not required to report on these matters unless he has any special comments to make on any of the items referred to therein. The auditor may also consider highlighting such comments in **thick** type or in *italics* which have any adverse effect on the functioning of the company. Another issue which arises is whether any observation or comment made by the auditor in respect of his statements on matters specified in CARO, 2003 issued under section 227(4A) of the Act, which has any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that section 227(4A) of the Act treats the comments on the matters specified in CARO, 2003 as a part of the auditor's report. Accordingly, any observation or comment made by the auditor in his report under CARO, 2003 contain such matters, which, in his opinion, will have any adverse effect on the functioning of the company, should also be reported in **thick** type or *italics* as required by this clause. An example in this regard may be where an auditor in respect of paragraph 4(i)(c) of CARO, 2003 reports that there exists a substantial doubt that without the replacement of significant part of fixed assets sold during the year, the company would be able to continue as a going concern for the foreseeable future.

Reporting under Section 227(3)(f) of the Act

12. Clause (f) of section 227(3) of the Companies Act, 1956, is reproduced below:

"227(3) The auditor's report shall also state –

.....

(f) whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274."

13. In order to report upon clause (f) of sub-section (3) of section 227 of the Act, it is essential that the auditor understands the requirements of clause (g) of sub-section (1) of section 274 of the Act. The relevant extracts of section 274(1)(g) referred to in clause (f) of section 227(3), are reproduced below:

"274(1) A person shall not be capable of being appointed director of a company, if—

.....

(g) such person is already a director of a public company which –

(A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999; or

(B) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more;

Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public

III.98 Auditing Pronouncements

company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B)."

14. On a perusal of section 227(3)(f), it is apparent that the auditor of a company, public or private, has to report on whether any of the directors of the company is disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act. This is because while clause (f) of section 227(3) is the operating clause, clause (g) of sub-section (1) of section 274 is the defining clause. Thus, in order to be able to make a statement pursuant to clause (f) of sub-section (3) of section 227 of the Act in his report, the auditor would need to satisfy himself as to whether any of the directors of the company is disqualified under section 274(1)(g) from being appointed as a director in a company. It may also be noted that where none of the directors of a private company have been directors in a public company, the disqualification mentioned under section 274(1)(g) would not get attracted since the disqualification under the said section is defined in respect of a person who is director of a public company.

15. Disqualification of a director for being appointed as a director of a company under section 274(1)(g) should be determined with reference to a particular date only. This is so because a director can become disqualified under the said section at any point of time during the year. Further, a director can attract the disqualification if any of the defaults mentioned under section 274(1)(g) is either done by the company being audited (if the company being audited is a public company) or any other public company in which a director of the company being audited is a director or has been a director in a public company which incurred the defaults and the period of five years has not elapsed. These factors make it impracticable for an auditor to determine whether any of the directors of the company attracted the disqualification under section 274(1)(g) at any point of time during the period covered by the auditor's report. It is, therefore, practicable that whether any of the directors of the company has attracted disqualification should be considered as on a particular date, namely, at the balance sheet date.

16. The Department of Company Affairs³ ("the Department") vide its Notification numbered GSR 830(E) dated October 21, 2003, has issued "The Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 (hereinafter referred to as the "Rules") to carry out the purpose of clause (g) of sub-section (1) of section 274 of the Act. The text of the Rules is reproduced in **Appendix I** to this Guidance Note.

17. The Rules are applicable to all public limited companies. However, the question regarding the applicability of the Rules to a company, which has been granted license under section 25 of the Act, and a private company, which is a subsidiary of a body corporate incorporated outside India, is required to be examined.

18. Section 25 of the Act only contains conditions subject to which the Central Government may dispense with the requirement to use the word "limited" or "private limited" in the name of a company. Thus, a public company, which is granted a license under section 25 of the Act,

³ Now "Ministry of Company Affairs".

continues to be a public limited company under the Act and therefore the Rules would be applicable to such a public limited company.

19. As far as a private company, which is a subsidiary of a body corporate incorporated outside India is concerned, it may be noted that section 4(7) of the Act provides that:

“(7) A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India.”

20. By virtue of section 3(iv)(c), a private company, if it is a subsidiary of a body corporate incorporated outside India, which if incorporated in India would have been a public company and some part of its share capital is held by a legal entity in India, would become a public company within the meaning of the Act. Therefore, the Rules would also be applicable to such a private company.

DISQUALIFICATION UNDER SECTION 274(1)(G)

21. The situation for disqualification of a director, as envisaged in sub-clause (A) of clause (g) of section 274 (1) of the Act is that the concerned public company has not filed the annual accounts and annual returns for any continuous three financial years commencing on or after the first day of April 1999. Further, sub-rule (a) of Rule 3 lays down that in such a case, persons who are directors on the last due date for filing the annual accounts and the annual returns shall be disqualified from being appointed as a director of another public company. In this context, it is also necessary to understand as to what is the “last due date” as envisaged by the Rules. The last due date would mean the due date with reference to the annual accounts and annual returns of the last of the three consecutive financial years for which the annual accounts and annual returns have not been filed. The proviso to clause (g) of sub-section (1) of section 274 provides that the period of five years would be reckoned from the date as specified in sub-clause (A), on which the public company failed to file its annual accounts and annual returns. From the above, it is clear that if the following conditions are satisfied in respect of a person, he would become disqualified under sub-clause (A) of clause (g) of sub-section (1) of section 274 of the Act:

- (a) The person is a director in a public company as on the last due date for filing the annual accounts and annual return for three continuous financial years. Thus, even if the person concerned has been appointed as a director in the public company only a few days before the last due date, the person would attract disqualification under section 274(1)(g). Further, a person who ceased to be a director of the public company as on the last due date for filing the annual accounts and annual return for three continuous financial years would not be disqualified from being appointed as a director of a public company.

III.100 Auditing Pronouncements

- (b) The public company has not filed the annual accounts and annual return for three consecutive financial years. Thus, if the said failure is not for a period of three continuous financial years, the disqualification would not be attracted.
- (c) The public company has failed to file both, the annual accounts and annual return. Thus, if the company has filed either the annual accounts or annual return within the due dates, the disqualification would not be attracted.
- (d) The period of five years has not elapsed since the date of default made by the public company. Thus, if the period of five years has elapsed since the date of the default, the person concerned shall not remain disqualified under sub-clause (A) of section 274(1)(g).

22. The situation for disqualification of a director, as envisaged in sub-clause (B) of clause (g) of section 274 of the Act is that the concerned public company has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for a period of one year or more. Further, sub-rule (b) of Rule 3 provides that if a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company would stand disqualified immediately on expiry of one year from the respective due dates. The proviso to the Rule further provides that that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will also be disqualified. It may also be noted that that the disqualification on account of the reasons cited under sub-rule (b) of Rule 3 of the Rules is also applicable to the reappointment as a director.

23. The explanation to Rule 3, however, clarifies that a company would not be considered as having defaulted in payment of the dividend referred to in sub-clause (B) of clause (g) of section 274(1) in the following situations:

- (i) The dividend in question has not been claimed; or
- (ii) The dividend in question has been transferred to a separate bank account, i.e., the Unpaid Dividend Account of the company in accordance with the requirements of section 205A of the Act; or
- (iii) The dividend in question has been paid into the Investor Education and Protection Fund as required under section 205C of the Act.

24. The Department has also issued certain Circulars/Notifications in respect of operation/applicability of clause (g) of section 274(1) of the Act. A gist of these Notifications/Circulars is as under:

- (i) In respect of sub clause (B) of clause (g) of section 274(1) of the Act, the Department, vide its general circular numbered 5 of 2003 (F No. 2/5/2001-CLV) dated 14-1-2003 has clarified that default in repayment of privately placed bonds/ debentures/ debt instruments by public financial institutions will not be considered as default to disqualify directors under section 274(1)(g) of the Act.

- (ii) The Department has, vide its notification numbered GSR 829(E), also clarified that the provisions of clause (g) of sub section (1) of section 274 of the Act shall not be applicable to a Government company.
- (iii) Further, the Department has also clarified, vide its general circular numbered 8/2002, dated 22-3-2002, that the nominee directors appointed by the public financial institutions and companies established under the Act of Parliament having non obstante provisions over the Companies Act, 1956 like IDBI, LIC, UTI, IIBI, etc., in their respective statutes shall not be liable to be disqualified under section 274(1)(g) of the Act. The Department has also clarified that the nominee directors appointed on the boards of assisted concerns or other public companies by (a) public financial institutions within the meaning of section 4A of the Act; (b) Central or State Government; and (c) banking companies are also exempt from the provisions of section 274(1)(g) of the Act.

25. The proviso to sub-section (1) of section 252 of the Act requires that a public company having a paid-up capital of rupees five crores or more; or one thousand or more small shareholders may have a director elected by such small shareholders in the manner as may be prescribed. The Department had, vide its Notification No. GSR. 168(E), dated March 9, 2001, issued the "Companies (Appointment of the Small Shareholders' Director) Rules, 2001. The said Rules define "small shareholders" as "a shareholder holding shares of nominal value of twenty thousand rupees or less in a public company to which section 252 of the Act applies. The said Rules deal with the manner of election of small shareholders' director, disqualification of such directors and vacation of office by such directors. Rule 5 of the said Rules which deals with the disqualification of small shareholders' directors lists out certain conditions wherein a person shall not be capable of being appointed as a small shareholders' director of a company. The said Rule 5, however, does envisage the situations outlined in clause (g) of section 274(1) as a condition for disqualification. Thus, a logical interpretation of the situation would be that a person appointed as a small shareholders' director pursuant to the above mentioned Rules would not be subject to any disqualification arising in terms of clause (g) of section 274(1) of the Act.

26. The Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 (the "Rules") have also introduced the concepts of "Disqualifying" and "Appointing" companies. As per Rule 2, a "disqualifying" company is "the company in which the default has occurred on account of which a director stands disqualified". Further, Rule 2 also defines an "appointing" company as "the company in which an individual is seeking an appointment as a director, including reappointment as a director". However, this distinction between the "appointing company" and "disqualifying company" apparently has no significance to the auditor since he is required to state in his report on the financial statements of the company whether any of the directors of the company as on the balance sheet is disqualified from being appointed as a director of a company under section 274(1)(g) of the Act.

27. Under Rule 9, every director in a public company registered under the Companies Act, 1956, is required to file Form DD-A, as prescribed in the Rules, before he is appointed or reappointed in any company. Rule 5 also casts a duty on every company which has failed to file its annual accounts and returns and/or fails to repay any deposit, interest, dividend, or fails

III.102 Auditing Pronouncements

to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274 of the Act, to immediately file a return in duplicate in Form DD-B (prescribed in the said Rules) with the Registrar of Companies.

28. Another point to note is that the provisions of clause (g) of section 274(1) of the Act do not find a place in the provisions of section 283 of the Act, which deals with vacation of office by the director(s). Therefore, a director should not be construed as having vacated his office merely because of his having incurred a disqualification under clause (g) of section 274(1) of the Act. Another question that arises in this regard is whether in case all the directors of a company are disqualified under section 274(1)(g), whether such directors can approve the financial statements of the company. As mentioned, in case a director of a company becomes disqualified from being appointed as a director in a company in terms of section 274(1)(g) of the Act, he continues to be a director of the company until the expiry of his term. Therefore, even in a case where all the directors become disqualified from being appointed as a director in a company they can approve the financial statements and continue to discharge the duties and responsibilities assigned by the Act.

DUTIES OF THE AUDITOR UNDER THE RULES

29. Rule 4 of the Rules deals with the duties of the statutory auditors of both the disqualifying as well as the appointing companies. Sub-rule (a) of Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company to:

- (i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and
- (ii) furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.

30. It is, therefore, clear that the statutory auditors of both the disqualifying as well as the appointing company would, in addition to their report in terms of section 227(3)(f) of the Act, would also have to, each financial year, furnish a certificate as required in Rule 4.

31. Sub Rule (b) of Rule 4 further casts a duty on the statutory auditors of the “disqualifying” company to report to the members of the company as required under section 227(3)(f) whether any director in the company has been disqualified during the year from being reappointed as director, or being appointed as a director in another company under clause (g) of section 274(1).

Auditor’s Procedures for Compliance with Section 227(3)(f) and the Rules

32. In order to comply with the requirements of section 227(3)(f) of the Act and the Rules, the auditor should obtain a written representation as to:

- (a) Names of directors of the company during the period covered by the auditor’s report (including the directors at the balance sheet date), showing separately, the names of

nominee directors and directors appointed in accordance with the Companies (Appointment of the Small Shareholders' Director) Rules, 2001

- (b) Particulars of appointment/reappointment, resignation/retirement etc., of each of the above directors.
- (c) Whether in case of directors appointed on or after the date of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 coming into effect, each such director has submitted Form DD-A, as required under the said Rules.
- (d) That the information contained in the register of directors maintained under section 303(1) is updated to show the position as on the balance sheet date.
- (e) Whether the company has committed any default as envisaged in sub-clauses (A) and/or (B) of clause (g) of section 274 (1) of the Act.
- (f) In case the company has committed a default under sub-clauses (A) and/ or (B) of clause (g) of section 274(1) of the Act, whether the company has furnished the Form DD-B, as required by the Rules.

33. The auditor should also obtain a written representation from the directors of the company as to whether they have attracted the disqualification in terms of clause (g) of sub-section (1) of section 274 of the Act. The auditor should require the directors to submit a written representation in respect of each public company in which they are directors as to whether as on the balance sheet date the public companies of which he is a director have defaulted in terms of the section 274(1)(g). There is a practice amongst many companies that the directors obtain a legal compliance report, periodically, to ensure that the companies have complied with all the legal requirements. Such compliance reports generally also contain the information regarding filing of annual accounts and annual return and compliance with clause (g) of sub-section (1) of section 274 can be a part of the said legal compliance report. Such a compliance report can, therefore, be submitted by the director as an evidence in this regard. In addition to written representation obtained from the director in respect of public companies of which he is a director, the auditor should also obtain written representation from the director in respect of each of those public companies in which he was a director in the past as to whether or not the director is disqualified to be appointed as a director in terms of proviso to Section 274(1)(g). The auditor should insist that written representations provided by the management as well as the directors appointed prior to the issuance of Rules or the legal compliance report, as the case may be, should be taken on record by the Board of Directors of the company being audited. However, in no case, is the auditor of either the appointing company or the disqualifying company expected to make any roving enquiries from such other companies in which the concerned director is also a director, as to whether or not they have committed any default in terms of sub clauses (A) and/ or (B) of clause (g) of section 274(1) of the Act.

34. The auditor should verify the information provided by the management and the directors from the information contained in the register maintained under section 303(1) of the Act. The said register contains various particulars relating to all the directors of the company including

III.104 Auditing Pronouncements

particulars in respect of the office of director, managing director, etc. The auditor can also examine the Form 32 filed by the company during the financial year under section 303(2) of the Act so as to know the changes, for example, appointment, retirement, resignation etc., of directors during the year. Form DD-A filed by the directors would also assist the auditor in assessing whether any director appointed during the year, at the time of appointed, was disqualified under section 274(1)(g) of the Act.

35. In case company being audited happens to be a public company which has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after 1st April, 1999; or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; then the auditor must report that all the directors are disqualified from being appointed as director in terms of clause (g) of sub-section (1) of section 274 of the Act. The auditor, in such a case, should also examine the return in Form DD-B to be filed under the Rules. Form DD-B contains the particulars of directors during the relevant period.

36. Since the Rules are applicable to public limited companies only, Forms DD-A and DD-B would not be available to the auditor a private company. In such cases, the auditor's employs the same procedures to comply with the requirements of section 227(3)(f) which are applied by an auditor of a public company except that the auditor is not required to examine Forms DD-A and DD-B because of their non-availability in a private company.

37. The reporting under clause (f) of sub-section (3) of section 227 of the Act may be as follows, keeping in view the situation concerned:

- (a) Where all the directors of the company are able to produce the evidence as specified in paragraph 33 above that the public company/(ies) of which they are directors have not defaulted in terms of section 274(1)(g), the auditor may report as follows:

"On the basis of the written representations received from the directors, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956".

- (b) In a situation where a director is unable to produce the written representation as specified in paragraph 33 above, the auditor may report as follows:

"Mr. X, who is also a director of ABC Ltd., has not produced written representation as to whether ABC Ltd., in which Mr. X is a director as on 31st March, 2XXX, had not defaulted in terms of section 274(1)(g) of the Companies Act, 1956. In the absence of this representation, we are unable to comment whether Mr. X is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956. As far as other directors are concerned, on the basis of the written representations received from such directors, and taken on record by the Board of Directors, we report that none of the remaining directors is disqualified as on 31st March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956."

- (c) Where on the basis of the written representation received from a director, it is noted that the director was disqualified from being appointed as a director under this clause, the auditor may report as follows:

“On the basis of the written representation received from Mr. Y, who is a director of ABC Ltd., as on 31st March 2XXX, and taken on record by the Board of Directors, we report that he is disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

As far as other directors are concerned, on the basis of the written representations received from such directors, and taken on record by the Board of Directors, we report that none of the remaining directors is disqualified as on 31st March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.”

Certificate under the Rules

38. As mentioned, sub-rule (a) of Rule 4 requires that it shall be the duty of the statutory auditor to furnish a certificate each year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not. The Rules, however, are silent as to whom the said certificate would be addressed. An interpretation could be that the auditor should furnish such a certificate to the shareholders of the company. However, this does not seem to be logical since the shareholders would get the same information from the auditor's statement in respect of clause (f) of sub-section (3) of section 227 of the Act. Therefore, it would be appropriate that the certificate is addressed to the Board of Directors of the Company. It may also be noted that the Rules are also silent as to the format and contents of the certificate. An illustrative format of the said certificate is given in **Appendix II**, which may be used by the auditors.

Appendix I

PUBLISHED IN THE GAZETTE OF INDIA, PART II, SECTION 3(i), EXTRAORDINARY

Ministry of Finance

(Department of Company Affairs)

NOTIFICATION

New Delhi, the 21st October, 2003

G.S.R. 830 (E).- In exercise of the powers conferred by clause (b) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules to carry out the purpose of clause (g) of sub-section (1) of section 274 of the said Act, namely :-

1. Short Title, Commencement and Extent

- (1) These rules may be called the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003.

III.106 Auditing Pronouncements

- (2) These rules shall come into force from the date of their notification in the Official Gazette.
- (3) These rules shall apply to all public limited companies registered under the Companies Act, 1956.

2. Definitions

In these Rules, unless the context otherwise requires, -

- (a) “disqualifying company” is the company in which the default has occurred on account of which a director stands disqualified;
- (b) “appointing company” is the company in which an individual is seeking appointment as a director, including re-appointment as director.

3. Disqualifications under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956

- (a) Whenever a company fails to file the annual accounts and annual returns, as described in sub-clause (A) of clause (g) of sub-section (1) of section 274, persons who are directors on the last due date for filing the annual accounts and the annual returns for any continuous three financial years commencing on and after the first day of April, 1999, shall be disqualified.
- (b) If a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company shall stand disqualified immediately on expiry of that one year from the respective due dates:

Provided that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will be disqualified:

Provided further that disqualification on account of the reasons cited under this Rule shall also apply to the reappointment as a director.

Explanation-For the purpose of this rule, it is clarified that non-payment of dividend referred to in sub-clause (B) of clause (g) of sub-section (1) of section 274 due to the reason of dividend not being claimed or kept in separate bank account as required under section 205A of Companies Act, 1956 or paid into Investors Education & Protection Fund as required under section 205C of that Act shall not be deemed to be a failure to make payment of dividend.

4. Duty of Statutory Auditor to Report on Disqualification

- (a) It shall be the duty of statutory auditor of the appointing company as well as disqualifying company, as required under section 227(3)(f) to report to the members of the company whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274 and to furnish a certificate each year as to whether on the

basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not.

- (b) It shall be the duty of the statutory auditors of the “disqualifying company” as required in section 227(3)(f) to report to the members of the company whether any director in the company has been disqualified during the year from being re-appointed as director, or being appointed as director in another company under clause (g), of sub-section (1) of section 274.

5. Duty of Company to Intimate Disqualification

Whenever a company fails to file the annual accounts and returns, or fails to repay any deposit, interest, dividend, or fails to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274, the company shall immediately file a return in duplicate in Form ‘DD-B’, prescribed under these rules for this purpose, to the Registrar of Companies, furnishing therein the names and addresses of all the Directors of the company during the relevant financial years:

Provided that names of such directors who have been exempted from application of Section 274(1)(g) by the Central Government, from time to time, shall be excluded.

Provided further that no unusual abbreviations or short forms shall be used in filling up the Form ‘DD-B’, which shall give such details as may be necessary to distinguish and identify each director without any ambiguity.

6. Failure to Intimate Disqualification Shall render Director as Officer in Default

When a company fails to file the Form ‘DD-B’ as above within 30 days of the failure that would attract disqualification under Section 274(1)(g), officers of the company listed in section 5 of the Companies Act, 1956 shall be officers in default.

- 7.(a) Upon receipt of the Form ‘DD-B’ in duplicate under Rule 5, the Registrar of Companies shall immediately register the document and place one copy of it in the document file for public inspection.
- (b) The Registrar of Companies shall forward the other copy to the Central Government.

8. Names of the Disqualified Directors on the Website etc.

- (a) The Central Government shall place on the web site of the Department of Company Affairs the names and addresses and such other details including names and details of the companies concerned, as may be necessary, in respect of all the disqualified directors.
- (b) The Central Government may also publicize the names of disqualified directors in such manner as it may consider appropriate.
- (c) The Central Government shall take such steps as may be required to update its web-site to ensure that name of the person, in whose respect disqualification period has expired after 5 years, is deleted from the web-site.

III.108 Auditing Pronouncements

9. Duty of Every Director

Every director in a public company registered under the Companies Act, 1956 shall file Form 'DD-A', prescribed under these Rules, before he is appointed or re-appointed.

10. If any question arises as to whether these rules are or are not applicable to a particular company, such question shall be decided by the Central Government.

11. Punishment for Contravention of the Rules

If a company or any other person contravenes any provision of these rules for which no punishment is provided in the Companies Act, 1956, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first, during which the contravention continues.

12. On the commencement of these rules, all rules, orders or directions in force in relation to any matter for which provision is made in these Rules shall stand repealed, except as respects things done or omitted to be done before such repeal.

[F. No.1/8/2002-CL.V]

Rajiv Mehrishi,
Joint Secretary

FORM 'DD-A'

Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003

Intimation by Director

[Pursuant to Section 274(1)(g)]

Registration No. of Company _____

Nominal Capital Rs. _____

Paid-up Capital Rs. _____

Name of Company _____

Address of its Registered Office _____

To

The Board of Directors
of _____

I _____ son/daughter/wife of _____ resident of _____ director/managing director/manager in the company hereby give notice that I am/was a director in the following companies during the last 3 years:

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

I further confirm that I have not incurred disqualification under section 274(1)(g) of the Companies Act, 1956 in any of the above companies, in the previous financial year, and that I, at present, stand free from any disqualification from being a director.

or

I further confirm that I have incurred disqualifications under section 274(1)(g) of the Companies Act, 1956 in the following company(s) in the previous financial year, and that I, at present stand disqualified from being a director.

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

Signature
(Full Name)

Dated this _____ day of _____

FORM 'DD-B'
Report by a Public Company

[Pursuant to Section 274(1)(g) read with Rule 5 of Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003]

Registration No. of Company: _____

Nominal Capital Rs. _____

Paid-up Capital Rs. _____

Name of Company _____

Address of its Registered Office _____

To

The Registrar of Companies,

It is hereby reported under section 274(1)(g) of Companies Act, 1956, that M/s. _____ have failed to (i) file the annual accounts and annual returns for the last three financial years, or (ii) repay deposits or interest thereon on due date being _____ or redeem its debentures on due date being _____ or pay dividend declared by the company since _____ or both. The period of one year has expired on _____.

III.110 Auditing Pronouncements

The name and address of directors at the relevant period are as under :-

- (a) Director's name in full, without abbreviations
- (b) Director's name as per company's records (abbreviations may be expanded and shown)
- (c) Address of the Director
 - (i) Permanent
 - (ii) Present
- (d) Positions held by the director in the last 5 years, prior to disqualification:

Signature
Designation*

Dated this _____ day of _____

*State whether Director, Managing Director, Manager or Secretary

Appendix II

FORMAT OF THE CERTIFICATE TO BE ISSUED UNDER RULE 4 (a) OF THE COMPANIES (DISQUALIFICATION OF DIRECTORS UNDER SECTION 274(1)(g) OF THE COMPANIES ACT, 1956) RULES, 2003

Auditor's Certificate

Rule 4 (a) of the Companies (Disqualification of Directors Under section 274(1)(g) of the Companies Act, 1956) Rules, 2003

To,

The Board of Directors of _____ (name of the company)

In terms of Rule 4(a) of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003, I/we (name of the chartered accountant/ firm, as the case may be), based on our examination of the books and records of the company, carried out in accordance with the requirements of the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, do hereby certify that none of the directors of the company, i.e., (name of the company) as on _____ (date of the balance sheet) is disqualified for appointment as a director in the aforementioned company in terms of clause (g) of sub section (1) of section 274 of the Companies Act, 1956.

Date:

For XYZ & Co.,
Chartered Accountants

Address:

.....
(Signature)
(Name of the Member Signing the Certificate)
(Designation⁴)
.....
(Membership Number)

⁴ Partner or proprietor, as the case may be.

GUIDANCE NOTE ON COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)*

INTRODUCTION

1. The overall objectives and scope of an audit do not change when an audit is conducted in a computer information systems (CIS) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems.

2. The purpose of this Guidance Note is to provide guidance in the use of CAATs. This Guidance Note describes computer assisted audit techniques including computer tools, collectively referred to as CAATs. This Guidance Note applies to all uses of CAATs when a computer of any type or size is involved whether that computer is operated by the entity or by a third party.

DESCRIPTION OF COMPUTER ASSISTED AUDIT TECHNIQUES (CAATS)

3. Computer Assisted Audit Techniques (CAATs) are important tools for the auditor in performing audits. CAATs may be used in performing various auditing procedures, including the following:

- ◆ tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
- ◆ analytical procedures, for example, identifying inconsistencies or significant fluctuations;
- ◆ tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management ;
- ◆ sampling programs to extract data for audit testing;
- ◆ tests of application controls, for example, testing the functioning of a programmed control; and
- ◆ reperforming calculations performed by the entity's accounting systems.

* Issued in September, 2003

III.112 Auditing Pronouncements

4. CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software, and perform audit tests more efficiently. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance contained in an entity's information systems. CAATs may consist of package programs, purpose-written programs, utility programs or system management program. Regardless of the origin of the programs, the auditor substantiates their appropriateness and validity for audit purposes before using them. A brief description of the programs commonly used is given below.

- ◆ *Package Programs* are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- ◆ *Purpose-Written Programs* perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
- ◆ *Utility Programs* are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- ◆ *System Management Programs* are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Details of some of the techniques used are mentioned in the Appendix.

CONSIDERATIONS IN THE USE OF CAATS

5. When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques. In determining whether to use CAATs, the factors to consider include:

- ◆ the IT knowledge, expertise and experience of the audit team;
- ◆ the availability of CAATs and suitable computer facilities and data;
- ◆ the impracticability of manual tests;
- ◆ effectiveness and efficiency; and
- ◆ time constraints.

Before using CAATs the auditor considers the controls incorporated in the design of the entity's computer systems to which CAAT would be applied in order to determine whether, and if so, how, CAATs should be used.

IT KNOWLEDGE, EXPERTISE AND EXPERIENCE OF THE AUDIT TEAM

6. Standard on Auditing (SA) 401, "Auditing in a Computer Information Systems Environment" deals with the level of skill and competence the audit team needs to conduct an audit in a CIS environment. It provides guidance when an auditor delegates work to assistants with CIS skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on "availability of CAATs" and "suitable computer facilities".

AVAILABILITY OF CAATS AND SUITABLE COMPUTER FACILITIES

7. The auditor considers the availability of CAATs, suitable computer facilities and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package program and entity's computer. Additionally, the auditor may elect to use their own facilities, such as PCs or laptops.

8. The cooperation of the entity's personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of CAAT on the entity's system, and to provide copies of data files in the format required by the auditor.

IMPRACTICABILITY OF MANUAL TESTS

9. Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.

- ◆ Source information may be initiated electronically, such as by voice activation, electronic data imaging, or point of sale electronic funds transfer. In addition, some transactions, such as discounts and interest calculations, may be generated directly by computer programs with no specific authorization of individual transactions.
- ◆ A system may not produce a visible audit trail providing assurance as to the completeness and accuracy of transactions processed. For example, a computer program might match delivery notes and suppliers' invoices.
- ◆ In addition, programmed controlled procedures, such as checking customer credit limits, may provide hard copy evidence only on an exception basis.
- ◆ A system may not produce hard copy reports. In addition, a printed report may contain only summary totals while computer files retain the supporting details.

EFFECTIVENESS AND EFFICIENCY

10. The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:

- ◆ analyzing and selecting samples from a large volume of transactions;
- ◆ applying analytical procedures; and
- ◆ performing substantive procedures.

11. Matters relating to efficiency that an auditor might consider include:

- ◆ the time taken to plan, design, execute and evaluate CAAT;
- ◆ technical review and assistance hours;
- ◆ designing and printing of forms (for example, confirmations); and
- ◆ availability of computer resources

12. In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application. The initial planning, design and development of CAAT will usually benefit audits in subsequent periods.

TIME CONSTRAINTS

13. Certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

14. Where the time available to perform an audit is limited, the auditor may plan to use CAAT because its use will meet the auditor's time requirement better than other possible procedures.

USING CAATS

15. The major steps to be undertaken by the auditor in the application of CAAT are to:

- (a) set the objective of CAAT application;
- (b) determine the content and accessibility of the entity's files;
- (c) identify the specific files or databases to be examined;
- (d) understand the relationship between the data tables where a database is to be examined;
- (e) define the specific tests or procedures and related transactions and balances affected;
- (f) define the output requirements;
- (g) arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
- (h) identify the personnel who may participate in the design and application of CAAT;

- (i) refine the estimates of costs and benefits;
- (j) ensure that the use of CAAT is properly controlled;
- (k) arrange the administrative activities, including the necessary skills and computer facilities;
- (l) reconcile data to be used for CAAT with the accounting and other records;
- (m) execute CAAT application;
- (n) evaluate the results;
- (o) document CAATs to be used including objectives, high level flowcharts and run instructions; and
- (p) assess the effect of changes to the programs/system on the use of CAAT.

TESTING CAAT

16. The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. This should be done before reliance is placed upon CAAT. The nature, timing and extent of testing is dependent on the commercial availability and stability of CAAT.

CONTROLLING CAAT APPLICATION

17. The specific procedures necessary to control the use of CAAT depend on the particular application. In establishing control, the auditor considers the need to:

- (a) approve specifications and conduct a review of the work to be performed by CAAT;
- (b) review the entity's general controls that may contribute to the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and
- (c) ensure appropriate integration of the output by the auditor into the audit process.

18. Procedures carried out by the auditor to control CAATs applications may include:

- (a) participating in the design and testing of CAAT;
- (b) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;
- (c) asking the entity's staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;
- (d) running the audit software on small test files before running it on the main data files;
- (e) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;
- (f) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and

III.116 Auditing Pronouncements

- (g) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When the auditor intends to perform audit procedures concurrently with online processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

19. To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.

20. Audit procedures to control test data applications may include:

- ◆ controlling the sequence of submissions of test data where it spans several processing cycles;
- ◆ performing test runs containing small amounts of test data before submitting the main audit test data;
- ◆ predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total;
- ◆ confirming that the current version of the programs was used to process the test data; and
- ◆ testing whether the programs used to process the test data were the programs the entity used throughout the applicable audit period.

21. When using CAAT, the auditor may require the cooperation of entity staff with extensive knowledge of the computer installation. In such circumstances, the auditor considers whether the staff improperly influenced the results of CAAT.

22. Audit procedures to control the use of audit-enabling software may include:

- ◆ verifying the completeness, accuracy and availability of the relevant data, for example, historical data may be required to build a financial model;
- ◆ reviewing the reasonableness of assumptions used in the application of the tool set, particularly, when using modeling software;
- ◆ verifying availability of resources skilled in the use and control of the selected tools; and
- ◆ confirming the appropriateness of the tool set to the audit objective, for example, the use of industry specific systems may be necessary for the design of audit programs for unique business cycles.

DOCUMENTATION

23. The various stages of application of CAATs should be sufficiently documented to provide adequate audit evidence.

24. The audit working papers should contain sufficient documentation to describe CAAT application, including the details set out in the sections below:

(a) Planning

- ◆ CAAT objectives;
- ◆ CAAT to be used;
- ◆ Controls to be exercised; and
- ◆ Staffing, timing and cost.

(b) Execution

- ◆ CAAT preparation and testing procedures and controls;
- ◆ Details of the tests performed by CAAT;
- ◆ Details of inputs (e.g., data used, file layouts), processing (e.g., CAATs high-level flowcharts, logic) and outputs (e.g., log files, reports);
- ◆ Listing of relevant parameters or source code; and
- ◆ Relevant technical information about the entity's accounting system, such as file layouts.

(c) Audit Evidence

- ◆ Output provided;
- ◆ Description of the audit work performed on the output;
- ◆ Audit findings; and
- ◆ Audit conclusions;

(d) Other

- ◆ Recommendations to the entity management; and

In addition, it may be useful to document suggestions for using CAAT in future years.

ARRANGEMENTS WITH THE ENTITY

25. The auditor may make arrangements for the retention of the data files, such as detailed transaction files, covering the appropriate audit time frame.

26. In order to minimize the effect on the organisation's production environment, access to the organisation's information system facilities, programs/systems and data should be arranged well in advance of the needed time period

27. The auditor should also consider the effect of these changes on the integrity and usefulness of CAAT, as well as the integrity of the programs/system and data used by the auditor.

USING CAATS IN SMALL ENTITIES

28. Although the general principles outlined in this Guidance Note apply in small entity IT environments, the following points need special consideration:

- (a) The level of general controls may be such that the auditor will place less reliance on the system of internal control. This will result in greater emphasis on tests of details of transactions and balances and analytical review procedures, which may increase the effectiveness of certain CAATs, particularly, audit software.
- (b) Where smaller volumes of data are processed, manual methods may be more cost effective.
- (c) A small entity may not be able to provide adequate technical assistance to the auditor, making the use of CAATs impracticable.
- (d) Certain audit package programs may not operate on small computers, thus restricting the auditor's choice of CAATs. The entity's data files may, however, be copied and processed on another suitable computer.

Appendix

Examples of Computer Assisted Audit Techniques

Techniques	Description	Advantages	Disadvantages
Audit Automation	<ul style="list-style-type: none"> ◆ Expert Systems ◆ Tools to evaluate a client's risk management procedures ◆ Electronic working papers, which provide for the direct extraction of data from clients computer records ◆ Corporate and financial modeling programs for use as predictive audit test 	<ul style="list-style-type: none"> ◆ These techniques are more useful when auditors are using laptops which can be directly linked with the entity's system. 	<ul style="list-style-type: none"> ◆ Not applicable in the case of mainframe computers.

Audit Software	<ul style="list-style-type: none"> ◆ Software used by the auditor to read data on client's files, to provide information for the audit and/or to re-perform procedures carried out by the client's programs. 	<ul style="list-style-type: none"> ◆ Performs a wide variety of audit tasks ◆ Long term economies ◆ Reads actual records ◆ Capable of dealing with large volumes of transactions 	<ul style="list-style-type: none"> ◆ Requires a reasonable degree of skill to use ◆ Initial set up costs can be high ◆ Adaptation often needed from machine to machine
Core Image Comparison	Software used by the auditor to compare the executable version of a program with a secure master copy	<ul style="list-style-type: none"> ◆ Provides a high degree of comfort concerning the executable version of the program ◆ Particularly useful where only executable versions are distributed 	<ul style="list-style-type: none"> ◆ Requires a high degree of skill to set up and to interpret the results. ◆ Where programs have been recompiled the comparison may be invalidated as the program records everything as a difference ◆ Printouts are hard to interpret and the actual changes made are difficult to establish ◆ Availability restricted to certain machine types
Database Analysers	Software used by the auditor to examine the rights associated with terminals and the ability of users to access information on a database	<ul style="list-style-type: none"> ◆ Provides detailed information concerning the operation of the database ◆ Enhances the auditor's understanding of the database management system 	<ul style="list-style-type: none"> ◆ Requires a high degree of skill to set up and to interpret the results ◆ Restricted availability both as regards machine types and database management systems ◆ Specific and limited audit applicability
Embedded Code	Software used by the auditor to examine	<ul style="list-style-type: none"> ◆ Performs a wide variety of 	<ul style="list-style-type: none"> ◆ There is a processing overhead involved

III.120 Auditing Pronouncements

	transactions passing through the system by placing his own program in the suite of programs used for processing.	<p>audit tasks</p> <ul style="list-style-type: none"> ◆ Examines each transaction as it passes through the system ◆ Operates continuously ◆ Capable of identifying unusual transactions passing through the system. 	<p>because of the extra programs</p> <ul style="list-style-type: none"> ◆ Definition of what constitutes an unusual transaction needs to be very precise ◆ Precautions need to be taken over the output from the programs to ensure is security ◆ Precautions need to be taken to ensure that the program cannot be suppressed or tampered with ◆ Requires some degree of skill to use and to interpret the results
Log Analysers	Software used by the auditor to read and analyse records of machine activity	<ul style="list-style-type: none"> ◆ Provides detailed information on machine usage. ◆ Long term economies ◆ Effective when testing integrity controls 	<ul style="list-style-type: none"> ◆ Requires a high degree of skill to use and to interpret the results ◆ Limited availability as regards machine types ◆ High volume of records restricts extent of test
Mapping	Software used by the auditor to list unused program instructions	<ul style="list-style-type: none"> ◆ Identifies program code which may be there for fraudulent reasons. 	<ul style="list-style-type: none"> ◆ Very specific objective ◆ Requires a high degree of skill to use and to interpret the results ◆ Adaptation needed from machine to machine.
Modelling	A variety of software, usually associated with a microcomputer, enabling the auditor to carry out analytical	<ul style="list-style-type: none"> ◆ Can be a very powerful analytical tool ◆ Can enable the auditor to examine 	<ul style="list-style-type: none"> ◆ A high volume of data may need to be entered initially ◆ Results require careful interpretation

	reviews of client's results, to alter conditions so as to identify amounts for provisions or claims, or to project results and compare actual results with those expected	provisions on a number of different bases <ul style="list-style-type: none"> ◆ Very flexible in use ◆ Can provide the auditor with useful information on trends and patterns 	
On-line Testing	Techniques whereby the auditor arranges or manipulates data either real or fictitious, in order to see that a specific program or screen edit test is doing its work	<ul style="list-style-type: none"> ◆ Very widely applicable ◆ Easy to use ◆ Can be targeted for specific functions carried out by programs 	<ul style="list-style-type: none"> ◆ Each use satisfies only one particular objective ◆ Care must be taken to ensure that "live" data does not impact actual results
Program Code Analysis	An examination by the auditor of the source code of a particular program with a view to following the logic of the program so as to satisfy himself that it will perform according to his understanding	<ul style="list-style-type: none"> ◆ Gives a reasonable degree of comfort about the program logic ◆ The auditor can examine every function of the program code 	<ul style="list-style-type: none"> ◆ The auditor must understand the program language ◆ The auditor needs to check that the source code represents the version in the source library, and that this version equates to the executable version
Program Library Analysers	Software used by the auditor to examine dates of changes made to the executable library and the use of utilities to amend programs	<ul style="list-style-type: none"> ◆ Provides the auditor with useful information concerning the program library ◆ Identifies abnormal changes to the library 	<ul style="list-style-type: none"> ◆ Requires a high degree of skill to use and to interpret the results ◆ Availability restricted to certain machine types ◆ Only relevant when testing integrity controls

III.122 Auditing Pronouncements

		<ul style="list-style-type: none"> ◆ Useful when testing program security 	
Snapshots	Software used by the auditor to take a “picture” of a file of data or a transaction passing through the system at a particular point in time	<ul style="list-style-type: none"> ◆ Permits the auditor to examine processing at a specific point in time to carry out tests, or to confirm the way a particular aspect of the system operates 	<ul style="list-style-type: none"> ◆ Can be expensive to set up
Source Comparison	Software used by the auditor to compare the source version of a program with a secure master copy	<ul style="list-style-type: none"> ◆ Compares source code line by line and identifies all differences ◆ Useful when testing integrity controls or particularly important program procedures 	<ul style="list-style-type: none"> ◆ Other procedures are necessary to ensure that the executable version reflects the source code examined ◆ Requires some degree of skill to use and to interpret the results ◆ Availability restricted to certain machine types
Test Data - “Live”, “Dead”, Integrated Test Facility or Base Case System Evaluation	Fictitious data applied against the client’s programs either whilst they are running or in an entirely separate operation. The results of processing the fictitious data are compared with the expected results based on the auditor’s understanding of the programs involved	<ul style="list-style-type: none"> ◆ Performs a wide variety of tasks ◆ Gives considerable comfort about the operation of programs ◆ Can be precisely targeted for specific procedures within programs 	<ul style="list-style-type: none"> ◆ “Dead” test data requires additional work for the auditor to satisfy himself the right programs were used ◆ Care must be taken to ensure that “live” data does not impact actual results ◆ Technique can be expensive to set up and cumbersome to use ◆ Adequate for detection of major error but less likely to detect deep-

		◆ Long term economies	seated fraud
Tracing	Software used by the auditor to identify which instructions were used in a program and in what order	◆ Helps to analyse the way in which a program operates	<ul style="list-style-type: none"> ◆ There may be less costly ways to achieve the same objectives, although not in the same detail ◆ Requires a high degree of skill to use and to interpret the results ◆ Adaptation needed from machine to machine

GUIDANCE NOTE ON AUDIT OF CAPITAL AND RESERVES¹

The following is the text of the Guidance Note on Audit of Capital and Reserves, issued by the Council of the Institute of Chartered Accountants of India. The Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.

INTRODUCTION

1. Capital and reserves constitute the owners' funds. Capital comprises both the amounts contributed by the owners and the profits capitalised over a period of time (by way of issue of bonus shares in case of corporate entities or by way of crediting the retained earnings to the capital account in case of non-corporate entities).
2. Capital may consist of various classes of shares with varying voting rights in case of corporate entities.
3. Reserves are the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. Reserves comprise both capital and revenue reserves. Ordinarily, revenue reserves are retained earnings, whereas the capital reserves may constitute both retained capital profits and owners' contribution in the form of premium on issue of shares and surpluses resulting from re-issue of forfeited shares. Revaluation reserve arising from revaluation of fixed assets is also a capital reserve.
4. The auditor, in many audit engagements, particularly those relating to corporate entities, may find very few changes in the capital account and/ or reserve accounts. However, the transactions in the capital and reserve accounts are normally material in amount in addition to being significant in nature and, therefore, each transaction in these accounts requires careful attention.
5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out the audit of capital and reserves, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

¹ Issued in January, 2006. Attention of the readers is invited to the fact that prior to the issuance of this Guidance Note, the aspect of audit of Capital and Reserves was covered by paragraphs 8.1 to 8.18 of the Statement on Auditing Practices. The Statements was withdrawn pursuant to the issuance of the Guidance Note on Audit of Payment of Dividend in August 2005.

<i>Existence:</i>	that the recorded amounts of capital and reserves exist at the given date
<i>Occurrence:</i>	that the transactions recorded in the capital and reserve account(s) occurred during the period under audit
<i>Obligation:</i>	that the amounts appearing in the capital and reserves account(s) are in fact a liability of the entity
<i>Completeness:</i>	that there are no unrecorded transactions in respect of capital and reserves account(s)
<i>Measurement :</i>	that the transactions in the capital and reserves account(s) have been recorded at the proper amount
<i>Valuation:</i>	that the amounts recorded in the capital and reserve account(s) are recorded at appropriate carrying value
<i>Presentation and disclosure:</i>	that the items of capital and reserves have been disclosed, classified, and described in the financial statements in accordance with recognised financial reporting framework applicable to the client.

6. The principal objectives of the auditor in the examination of capital and reserves, therefore, are:

- (a) to ascertain that amounts shown in capital and reserve account(s) as at the balance sheet date are correct;
- (b) to determine that all transactions during the year, affecting owners' funds were properly authorised and recorded;
- (c) to examine whether the applicable laws and regulations and terms of issue/ agreement, if any, have been complied with; and
- (d) to verify whether these amounts have been properly classified and disclosed in the financial statements.

INTERNAL CONTROL EVALUATION

7. Paragraph 2 of the Standard on Auditing (SA) 400, *Risk Assessments and Internal Control*, requires the auditor to obtain an understanding of the accounting and internal controls relating to capital and reserves sufficient to plan the audit and develop an effective audit approach. Paragraph 1 of the SA 500 requires the auditor to "obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information". Paragraph 1 further states:

"Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system."

In certain cases, the client may employ a third party to carry out any of its transactions in respect of capital and/ or reserves. For example, it is quite common for listed companies to

III.126 Auditing Pronouncements

outsource the administrative aspects related to allotment, issuance of share certificates, share transfer, maintenance of records of shareholders, etc. In such situations, the auditor, as required by Standard on Auditing (SA) 402, "*Audit Considerations Relating to Entities Using Service Organisations*", should also consider how such arrangements affect the client's accounting and internal control system so as to plan and develop an effective audit approach.

8. In the case of non-corporate entities, the auditor needs to ascertain general terms and conditions regarding contribution of capital, interest payable on capital, interest chargeable on withdrawals, limits imposed on withdrawals, etc. In respect of corporate entities, the auditor should particularly review the following aspects of internal controls relating to capital and reserves:

- (a) *Proper authorisation of transactions*: All transactions in the capital and reserves accounts such as issue of fresh shares and allotment, buy back of shares, forfeiture, making calls on the shares, should be properly authorised as required by the Companies Act, 1956. Outsourcing of any services, e.g., depository services should also be with the proper authorisation of a competent authority. The authority to sign the share certificates may be delegated to a person as per the laws applicable to the entity.
- (b) *Proper control over issue and custody of share certificates*: In case where shares are in the physical form, the auditor is required to examine that proper internal control system exists to ensure that the share certificates are pre-numbered, proper accounts are maintained for certificates cancelled due to defacement, wear out, exhaustion of cages to record transfer particulars, dematerialisation. The auditor should examine whether blank share certificates are under the lock and control of the company secretary or some other responsible officer of the entity. He should also examine whether at least one officer of the entity personally signs the share certificates issued, though other signatures can be facsimile type and whether such a signing officer also verifies the register of share certificates, wherein the issue particulars are recorded. It may be noted that share certificates are generally issued for a fixed lot of shares (marketable lot, or some other predetermined denomination).
- (c) *Allotment and call intimations etc.*: The auditor should examine whether allotment of shares and calls is done pursuant to a resolution of the Board and that proper internal controls exist for despatch of allotment advices and call letters.
- (d) *Internal control on receipts and accounting of application, allotment and call money*: Internal controls applicable for receipt and accounting of money received on application, allotment and calls need to be evaluated. Proper records should be maintained for recording the said transactions. Periodical reconciliation of bank accounts opened specially for transactions in capital account have to be made.
- (e) *Maintenance of adequate records*: The auditor should verify whether proper system of internal controls for documentation is in operation. It includes maintenance of proper and adequately detailed records in respect of the details of members, share certificate stock ledger, duplicate certificates, cancelled certificates, etc.

- (f) *Proper control over issue of instructions to depository participants*: There should exist proper controls over issue of instructions to and for execution of requests received from the depository participants for the dematerialisation/re-materialisation of shares and proper records are required to be maintained for recording such transactions.

INTERNAL CONTROLS RELATING TO OUTSOURCED ACTIVITIES

9. For the efficient carrying out of the day to day transactions like issue of share certificates/instructions to depository participants for the credit of shares on allotment, either on public issue or rights issue, issue of call letters, etc., authority may be delegated, at the general meeting, to registrars and share transfer agents. In such cases, the auditor should follow the procedures described by the SA 402.

VERIFICATION

10. Verification of capital and reserves may be carried out employing the following procedures:

- (i) examination of records;
- (ii) examination of compliance with laws and regulations and terms of issue/ contract, if any; and
- (iii) examination of presentation and disclosure.

11. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

ENTITIES OTHER THAN PARTNERSHIPS AND SOLE PROPRIETORSHIPS

Examination of Records

Capital

Authorised Capital

12. The authorised capital shown in the balance sheet should be checked with the Memorandum of Association in case of a company, registered byelaws in case of a co-operative society, relevant statute or the Government Order in case of a statutory corporation or other body corporate. The auditor may also refer the audited balance sheet of the immediately preceding year.

13. The minutes of the general meeting and/ or Board should be examined to see, if any, change in the capital structure has taken place since the last balance sheet and whether it is properly authorised. A company, having a share capital, in terms of the provisions of section 94 of the Companies Act, 1956 may change its share capital as follows:

- (i) increase its share capital by such amount as it thinks expedient by issuing new shares
- (ii) consolidate or divide all or any of its share capital into shares of larger amount than its existing shares

III.128 Auditing Pronouncements

- (iii) convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid-up shares of any denomination
- (iv) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum
- (v) cancel shares which, at the date of passing of the resolution in that regard, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled

In such cases, the auditor should also examine the copy of the documents filed with the Registrar of Companies in relevant form along with the specified fee pursuant to the requirements of section 97 of the Companies Act, 1956. In addition to the situations envisaged in section 94 of the Companies Act, 1956, the auditor should also enquire whether the Central Government has, under Section 81(4) ordered or directed under Section 94A(2) of the Companies Act, 1956, the conversion of debentures or loans into share capital, resulting in an increase in the authorised capital of the company. The authorised capital may also undergo a change, as a consequence of a merger or a demerger. Similarly, in case of statutory corporations, amendments made to the statute governing the entity or the Government Order in case of other public sector bodies should be enquired into.

Issued and Subscribed Capital

14. *Issued Capital:* The following records/documents would ordinarily provide necessary evidence for issued capital:

- (a) The minutes of the general and/ or board meetings for further issue of shares, e.g., under section 81 of the Companies Act, 1956;
- (b) Offer documents, if any, filed with the Securities and Exchange Board of India (SEBI)/Registrar of Companies (ROCs) and Reserve Bank of India (RBI) in respect of permission in case of ADR/GDR issue.
- (c) Return of allotment filed with the Registrar of Companies.

15. *Subscribed Capital:* Shares subscribed in response to the issue of capital can be verified by reviewing the applications received for the subscription of shares. The subscribed capital is the capital for which the application money is received. The subscribed share capital cannot exceed the issued capital.

Paid up capital

16. Periodical reconciliation of outstanding shares held in demat and physical form as on book closure/ record date should also be done.

17. The auditor should review the minutes books of Board of Directors and the members and also any amendments made to the statutory register to ascertain whether any changes have taken place in the capital of the entity, for example –

- A. Increase in capital due to:
- (i) Fresh issue of shares/ADR/GDR.
 - (ii) Allotment of shares pursuant to merger/amalgamation or acquisition of property or services.
 - (iii) Part/full conversion of loans or debentures
 - (iv) Allotment of shares pursuant to exercise of option either by the promoters or the employees or other option holders.
 - (v) Allotment of Bonus shares
 - (vi) Rights issue
- B. Decrease in capital due to:
- (i) Forfeiture
 - (ii) Buy-back of shares
 - (iii) Redemption of redeemable preference shares
 - (iv) Reduction of capital
 - (v) Surrender of shares as in the case of Co-operative societies
 - (vi) De-merger

18. A list of members, together with shares held by them and the amounts paid-up thereon, should be available with the company/entity as at the balance sheet date and the aggregate of these should agree, with the details of capital shown in the balance sheet. A copy of the annual return for the previous year filed under the Companies Act, 1956 or any other statute or a list of members prepared for issuing dividend warrants may also be examined. If the auditor chooses to verify the list of members as per the annual return or list of members prepared for issuing dividend warrants, he should also check the reconciliation with the amount as at the balance sheet date, with the changes occurred during the period from the date of balance sheet and record date/ book closure date. Where the registration work is carried out by independent specialised agencies, a certificate, containing the list of members, the number of shares held, including those in the demat form and physical form and amount paid up on these shares and calls in arrears, if any, should be obtained and reconciliation of the particulars with the amount credited as paid up in the share capital account of the General Ledger be checked on a test basis.

19. If a change in the capital has taken place during the year under audit, inquiries should be made to ascertain that it is properly authorised in the manner prescribed by the Articles and appropriate resolutions have been passed with requisite majority.

20. The auditor should enquire whether the Central Government has passed any order under Section 108 or Section 250 of the Companies Act, 1956 freezing the voting rights of any shareholders. It may be noted that there are provisions in the Banking Regulation Act, 1949

III.130 Auditing Pronouncements

limiting the voting rights of a person. Similarly, the Co-operative Societies Act, 1912 provides for issue of two types of shares, one having voting rights and other not having voting rights. The Companies Act, 1956 also provides for issue of shares with non voting rights. These matters have a bearing while examining the validity of the resolutions passed by the members of the entity. The auditor should, therefore, also check that the classes of shares have been appropriately disclosed.

Subscription in Cash and Kind

21. The law requires a distinction to be made between shares subscribed for in cash and shares subscribed for consideration other than in cash. Shares subscribed for in cash should include only the following kinds of subscription: -

- (a) where the subscription amount is received either in cash or by cheque;
- (b) where the amount is adjusted against a *bona fide* debt payable in money at once by the company.

There might be situations where a company has taken a loan under a stipulation that in case of default in repayment of the loan, the loan would get converted into shares. In such a situation, on a default in repayment of the loan by the company, if the loan gets converted into shares in the company, such shares would be considered as having been allotted for cash. Where shares are allotted against credit balance in a person's account, inquiry should be made as to how the credit balance in that account has arisen, whether it was for a valid consideration and whether the amount was due for payment at the time of issue.

22. The Department of Company Affairs² has clarified through its circular No. 8/32(75) 77-CL-V dated 13th March, 1978, that a genuine debt adjusted against the amount receivable towards share capital can be treated as amount paid in cash. The extracts from the advice received from an eminent Counsel in this regard are given as **Appendix A** to this Guidance Note.

23. Where the subscription for share capital is paid into a bank account in a foreign country, it should be verified that the amount deposited in the foreign currency is in accordance with the terms of issue and such an amount as, if remitted into India on the day on which the deposit is made in the foreign country, would have realised in Indian rupees a sum equal to the amount credited as paid up and premium, if any, on the shares. The auditor should verify that the guidelines issued by SEBI for inviting, collecting and recording of foreign capital have been complied with by the company. The foreign exchange fluctuations, if any, should be accounted for in the balance with bank in accordance with the provisions of Accounting Standard 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*.

24. *Issue of Shares for Consideration Other than Cash:* Shares may also be issued for a consideration other than cash, e.g., for supply of machinery or technical know-how. The auditor should examine the underlying agreement in respect of the same and verify whether the agreement has been properly approved. The auditor should treat the shares issued for

² Now known as the Ministry of Company Affairs.

consideration other than cash separate from those issued against cash in his audit approach. He needs to verify that the consideration for which shares are issued, viz., supply of machinery or technical know-how is *prima facie* fully received.

25. Further, as per the provisions of section 75 of the Companies Act, 1956, whenever company having a share capital makes any allotment of its shares, the company has to comply with the following conditions:

- i. It has to file with the Registrar of Companies, a return of the allotment, stating the number and nominal amount of shares comprised in the allotment, the names, addresses and occupations of the allottees, and the amount if any, paid or due and payable on the shares.
- ii. In case of shares allotted for other than cash, it has to produce before the Registrar, *inter alia*, a contract in writing, constituting the title of the allottee to the allotment together with any contract of sale, or a contract for services or other consideration in respect of which allotment was made.

26. The auditor may examine the following records to the extent they are applicable to the particular circumstances, in case of increase in paid-up capital:

- (a) Final price determined in case of offer through book building process³.
- (b) Scheme of compromise or arrangement as referred to in section 394 of the Companies Act, 1956, approved by the Court.
- (c) Compromise proposal with creditors and the consequential Order of the Court or an Order of Central Government under Section 397 of the Companies Act, 1956.
- (d) Procedure and terms of reissue of forfeited shares.

27. In case the payment is allowed to be made on allotment and/ or also in instalments of one or more calls, the auditor has to verify the resolution of the Board for making calls, amount received against the calls and the posting of the amount to the correct member's account/folio. A schedule of allotment money and a schedule for each call have to be verified on test check basis and reconciled with total amount received and due on allotment and each call. If the accounting work relating to the share capital is outsourced to a Registrar and Share Transfer Agent, the auditor should follow the principles enunciated in SA 402. If the Articles of Association permit and the terms of issue state that in the event of delay in payment of either allotment money or calls, the investor has to pay interest, the auditor should verify whether such interest is collected and properly accounted for in the books of account. The auditor should review the schedules of calls in arrears and calls in advance, and ensure that interest

³ *Book Building Process*: Listed companies can also issue shares through Book Building Process. Book Building is a process wherein the issuer of securities asks investors to bid for his securities at different prices. These bids are within an indicative price-band, decided by the issuer. Here, investors bid for different quantity of shares, at different prices. Considering these bids, the issuer determines a cutoff price, which is the price at which the securities are allotted. SEBI has issued guidelines on issue of shares through Book Building Process. The auditor has to verify whether the company has complied with all the guidelines issued by SEBI in this regard and also that the basis of determination of the floor price and the final price by the company is consistent with the provisions in that regard.

III.132 Auditing Pronouncements

is provided in accordance with the Articles of Association, Offer Documents/Terms of Issue. The auditor may verify the Board Resolution, if any, for waiver of interest on calls in arrears. Interest on calls in arrears may be accounted at the time of receipt, with proper disclosure in the balance sheet for deviating from the accrual principle. The schedule of calls in arrears should show separately the amounts, if any, due from the directors. Similarly, the auditor should also examine the payment of interest on calls received in advance, if any, made by the company. He should verify whether any such payment of interest on calls received in advance is permitted by the articles of association of the company. He should also examine the Board resolution in this regard.

28. In case shares are issued at discount, the auditor has to verify the compliance of Section 79 of the Companies Act, 1956.

29. Generally, employees are offered shares at a price lesser than the market rate. Sections 79 and 79A of the Companies Act, 1956 and SEBI (Employee Stock Option Scheme and Employees Stock Purchase Scheme) Guidelines, 1999 (ESOS and ESPS), Employee Stock Option Scheme for Public Sector Enterprises and others statues governing the entity have to be complied with. Transactions relating to options are to be accounted as required by the said scheme or the Accounting Standards and provisions of any relevant statute, if any, in force, on treatment of discount etc., on ESOS/ESPS.

30. *Issue of Sweat Equity*: Section 79A of the Companies Act, 1956 deals with the issue of sweat equity by the company to its employees and directors, at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. SEBI has also issued SEBI (Issue of Sweat Equity) Regulations, 2002 for issue of the sweat equity by the listed companies. The issue of sweat equity by unlisted companies is governed by Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003⁴. The auditor must verify that if the company has issued any sweat equity, whether the provisions of Section 79A of the Companies Act, 1956 and the Rules applicable to the company, depending whether listed or not, have been complied with.

31. Companies are now allowed to buy-back their own shares. Sections 77A and 77B of the Companies Act, 1956 lay down the conditions and procedures for buy-back of the shares of a company. In case of private limited and unlisted companies, the Private Limited Company and Unlisted Public Limited Company (Buy-back of Securities) Rules 1999, and in case of listed companies, SEBI (Buy-back of Securities) Regulations, 1998 have to be complied with. The auditor should verify particularly that the funds employed for the buy-back are from the resources as permitted by the law. The reconciliation of entries in escrow account or the bank account separately opened for payment of purchase consideration have to be verified with the number of shares bought back and price paid. The auditor should also verify the entries made in the concerned books/registers with regard to destruction of share certificates and extinguishments of dematerialised shares and a reconciliation of these two to arrive at the total number of securities purchased under buy- back process.

⁴ Issued by the Ministry of Company Affairs vide Notification number GSR 923E dated 4th December, 2003.

32. Registered Byelaws of the Co-operative Societies specify the terms and conditions for surrender of all or certain class of shares. Generally, surrender of shares is allowed only at par. The auditor has to verify the certificates surrendered vis-à-vis the payment made and the entries made in the Register of members, share certificate ledger etc.

33. In case of reduction of capital is by way of reduction of the nominal value of the shares, either by canceling unpaid portion of the partly paid shares, or extinguishing some part of the paid up capital, the auditor has to verify that the High Court Order under Section 100 of the Companies Act, 1956 for reduction of capital has been complied with. Further, he has to verify the share certificates surrendered and the statement of corresponding new share certificates issued. In case reduction is achieved by canceling fully paid shares proportionately, the auditor should also verify the surrendered shares/issue of stickers/intimation to the depositories vis-à-vis the amount reduced.

34. It may be noted that the buy-back of shares under Section 77A and redemption of redeemable preference shares under Section 80 do not attract the provisions of Section 100 of the Companies Act, 1956.

Application Money

35. Schedule VI to the Companies Act, 1956 does not prescribe the manner of disclosure of share application money. However, as a matter of prudence and better disclosure, share application money should be shown separately between "Share Capital" and "Reserves & Surpluses" in the Balance Sheet till the time share application money is transferred to the Share Capital Account. However, in the following situations, the share application money would be disclosed separately under the head "Current Liabilities" in the Balance Sheet:

- invalid or revoked applications;
- excess application money received due to over subscription; and
- when minimum subscription stated in the offer document is not received.

36. The auditor has to verify whether application money stated is fully backed by the share application forms/certificate from the Share Transfer Agent and applications are received pursuant to a resolution of the appropriate authority for issue of capital. Amount received without satisfying any of the above conditions should be refunded by the company.

37. Share application money accepted by the company, if not backed by the application form/Registrar's certificate alongwith the resolution of the Board as stated above, should be treated as unsecured loan. The auditor should verify that the application money received in excess of capital offered for subscription, if any, has been stated under Current Liabilities. The auditor may examine the reasonableness of the period for which the share application money remains pending allotment.

38. In case of refund of excess application money/revoked applications, the auditor should verify the same and apply the similar audit procedures as applied for audit of any other liability. The auditor should also verify whether the company has complied with the Guidelines prescribed by SEBI with regard to time schedule and payment of interest in case of delay in such refunds.

III.134 Auditing Pronouncements

Calls Received in Advance

39. The auditor should examine whether the calls received in advance and payment of interest, if any, thereon is in accordance with the provisions contained in the Articles of Association in this regard. Schedule of calls received in advance is to be reviewed with reference to the amounts deposited in the bank.

40. Interest, if any, paid on the amount received in advance of calls should be verified and the audit procedure to be employed is same as in case of payment of interest on borrowings.

General

41. The auditor should examine whether proper accounts have been maintained with regard to amounts received on application, allotment and calls and the payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where shares are issued at a premium, the auditor should ensure that such sums are accounted for separately. In case of buy back, reissue or redemption of preference shares and reduction of capital by payment of money, the auditor should examine whether these have been properly accounted and duly reconciled with payments made for the same.

42. Proviso to section 383A of the Companies Act, 1956 requires certain companies to obtain a certificate of compliance with the provisions of the Companies Act, 1956 from a practicing company secretary. The auditor of such companies may review the same.

Reserves

43. Reserves should be distinguished from provisions. For this purpose, reference may be made to the definitions of the expressions, "provision" and "reserve", etc., in the Guidance Note on Terms Used in Financial Statements issued by the Institute. The definition of the term "reserve" as given in the said Guidance Note is explained in paragraph 3. It is important to remember that any amount provided in excess of the requirements is in the nature of reserve and should be shown as such.

44. It is also necessary to make a distinction between capital reserves and revenue reserves in the accounts. A Revenue Reserve is ordinarily available for distribution as dividend.

45. Reserves may also contain amount received from the Government. These grants may be in the nature of promoters' contribution or related to any specific fixed asset. The auditor should verify that the principles of Accounting Standard 12, *Accounting for Government Grants* for recognition, presentation, refund, if required, and disclosure of the grant have been appropriately complied with.

46. A reserve account is styled as Reserve Fund only when such reserves are represented by specifically earmarked assets or investments.

47. In case of amalgamations and mergers, reserves of the amalgamated /merged company have to be treated as prescribed in Accounting Standard 14, *Accounting for Amalgamations* issued by the Institute. However, the auditor, especially in cases of amalgamations/ mergers, may come across a situation where the relevant Court/ Tribunal has made an order sanctioning an accounting treatment different from that prescribed by an Accounting Standard.

In such a situation, the attention of the members is drawn to the announcement of the Council of the Institute in this respect. The Council has recommended that the following disclosures be made in the financial statements for the year in which different treatment has been given:

- (i) A description of the accounting treatment made alongwith the reason that the same has been adopted because of the Court/ Tribunal order.
- (ii) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.
- (iii) The final impact, if any, arising due to such a difference.

Capital Reserves

Capital Redemption Reserve

48. In terms of the provisions of sections 77A and 80 of the Companies Act, 1956, if the company redeems the preferential share capital or buys back its own shares, using the retained earnings, the amount equivalent to the nominal value of the shares redeemed/bought back have to be transferred to the capital redemption reserve, and such reserve can be utilised only for issue of bonus shares to the members of the company.

Securities Premium Account

49. Any premium realised on issue of securities should be transferred to Securities Premium Account and utilised only for the purposes laid down in section 78 of the Companies Act, 1956.

Government Grants

50. Grants, contributions and subsidies received from Government specifically for acquisition of assets have to be treated and disclosed in the financial statements as laid down in Accounting Standard 12, issued by the Institute.

Revaluation Reserve

51. Reserves arising out of revaluation of fixed assets are to be transferred to the Revaluation Reserve account. The treatment and utilisation of these reserves is governed by the "Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets" and "Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares" issued by the Institute.

Statutory Reserves

52. Section 17 of the Banking Regulation Act, 1949 and certain provisions in the Co-operative Societies Act, 1912 provide for creation and utilisation of certain specific reserves. Laws governing other entities may contain similar provisions as to the creation and utilisation of such reserves. The regulators may also direct the entities to create some specific reserves, for example, the Reserve Bank of India has directed all banking companies to create and transfer certain amount of profits earned on trading of investments to Investment Fluctuation Reserve and has also stipulated the purpose for which such reserve can be utilised. The

auditor should familiarise himself with such regulatory directions with respect to creation and utilization of such specific reserve and verify compliance therewith.

Revenue Reserves

53. A revenue reserve is a reserve, which is available for distribution as dividend. The auditor should examine the legal provisions governing the entity with regard to transfer of certain percentage of profits to reserves, for example, the requirements of section 205 (2A) of the Companies Act, 1956, the Reserve Bank of India Directions in case of Non Banking Financial Companies, etc.

54. Certain other statutes may require transfer of profits to reserves. For example, the Income-tax Act, 1961 may require creation of certain reserves and provide for rules for utilisation of such reserves to claim certain fiscal benefits. The auditor should examine the need for transfer of profits to reserves and utilisation of such transfers.

Examination of Compliance with Laws and Regulations

55. Standard on Auditing (SA) 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* requires that “when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non compliance by the entity with laws and regulations may materially affect the financial statements.” The auditor should therefore acquire sufficient knowledge of the legal and regulatory framework within which the client operates. This assumes added importance in cases of audit of capital and reserves of companies since the matters relating to the share capital and reserves are governed by the provisions of the Companies Act, 1956, especially the provisions contained in sections 69 to 116, section 177C, section 205(2A) of the said Act. For example, sections 69 to 116 of the Companies Act, 1956 regulate the matters relating to issue and allotment of shares, section 205 (2A) and section 177C of the Companies Act, 1956 contain provisions relating to creation and utilisation of certain reserves and section 187C deals with the situation where the beneficial owner of the shares of the company is different from the person whose name is appearing in the shareholders’ register of the company. Guidelines issued by the Securities and Exchange Board of India from time to time also contain the matters relating to the issue and allotment of shares in case of public offer and substantial acquisition of shares in case of existing listed companies. Moreover, the Articles of Association of the entity may also have provisions relating to share capital and reserves. The Companies Act, 1956 requires compliance with the Articles of Association in so far as they are not contradictory to the provisions of the Act. Hence, it is very important to verify the compliance with the laws and regulations governing the entity.

56. The State Co-operative Societies Acts may have conditions as to minimum paid up capital and also minimum number of members for co-operative societies and with regard to creation and utilisation of various reserves. Statutes governing the entity may contain similar provisions with regard to the number of members and minimum amount of capital. The auditor should be familiar with the laws governing the entity. The auditor has to carefully examine the compliance of such legal requirements.

57. The auditor has to examine the compliance with the various rules and regulations, for example:

- (a) Government Order, if any, the Memorandum and the Articles of Association of the company or the Rules and Regulations governing the entity.
- (b) Terms of issue attached or subsequently approved in case of conversion of loans or convertible preference shares.
- (c) Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and Guidelines on Euro Issues.
- (d) Rules and Regulations relating to issue and buy back of ADR/GDR.
- (e) Chapter XIII of SEBI (Disclosure and Investor Protection) Guidelines 2000 in case of preferential issue.
- (f) Unlisted Public Companies (Preferential Allotment) Rules, 2003.
- (g) Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.
- (h) Any other Rules and Regulations prescribed by Government/SEBI from time to time.

Examination of Presentation and Disclosure

58. The laws governing the entity may prescribe the format for disclosure of information relating to the Capital and Reserves in its Balance Sheet. For example, the Companies Act, 1956, the Banking Regulation Act, 1949, the Electricity Act, 2003 and Insurance laws prescribe the format of Balance Sheet and the manner of disclosure of the capital and reserves in the financial statements. The auditor should examine compliance with such disclosure requirements and adequacy thereof. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same are complied with, for example, SEBI requires that in case of public issue and preferential issue of shares and/or partly/fully convertible debentures, purpose for which these monies are utilised and the manner in which the unutilised money is invested should be disclosed. Sometimes, it may be necessary to disclose the information either in the Significant Accounting Policies and Notes on Accounts to clarify the matters, for example, any employee options outstanding, etc. The auditor should examine such necessity and consider whether appropriate disclosures such as those listed below have been made:

- Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) with or without payment being received in cash
- Aggregate number and class of shares allotted as fully paid by way of bonus shares
- Aggregate number and class of shares bought back
- Source of issuance of bonus shares during the year, if any
- Preference Share Capital, including terms of redemption or conversion
- Shares with differential rights

SPECIAL CONSIDERATIONS APPLICABLE TO PARTNERSHIP ENTITIES

59. The most significant document underlying the partnership form of organisation is the Partnership Deed.

60. The Partnership Deed generally provides the capital required to be contributed by the partners and their respective share in profits and losses and interest, if any, on the capital contributed or balances to their credit. The Partnership Deed may also provide for the treatment of excess capital contributed by any partner and their respective rights relating to the withdrawals from capital/drawing accounts.

61. It may be possible that one or more partners contributes the capital in kind rather than in cash. For example, the premises required for the business may be provided by a partner as his capital contribution. If such contributions are in kind at the time of admission of the partners, the value of such assets is generally mentioned in the Partnership Deed. If the value is not mentioned in the Partnership Deed, the auditor may request for a declaration of the value in writing by all the partners. He should also obtain necessary audit evidence for supporting the valuation.

62. The partnership deed may also provide for fixed capital contribution and timing of contribution by each partner. The auditor should examine whether the capital contributed by each of the partners is in accordance with the Partnership Deed and the capital is maintained at the level mentioned in the Partnership Deed throughout the period of audit.

63. If the Partnership Deed places any restrictions on the drawings of the partners, the auditor should examine whether the drawings have been within the permissible limit.

64. The auditor has to verify the correctness of the interest, if any, credited or debited to the partners' capital or drawings account.

65. Generally, remuneration, interest on capital, interest on drawings, profits or losses are adjusted in the capital accounts or the drawing accounts of the partners, and Reserve accounts are not maintained in case of partnership accounts. However, if fiscal or any other law require any reserve has to be created for claiming any benefit, a reserve with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve may be provided in the relevant laws. In such event, the auditor should examine the compliance with the same. Sometimes, the partners may decide to create and utilise certain reserves due the exigencies of the business, in which case the auditor has to verify the compliance of the decision of the partners. In case the entity has not complied with the prescribed reserve utilization requirements, he should consider the effect of the same on his audit report in terms of the principles laid down in the SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

66. Special Reserves, created to meet the requirements of any law, may be credited to the Partners' Capital Accounts on fulfillment of such statutory requirements or the terms of creation of such reserves.

67. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

68. Where either investments or drawings have come from Non Resident Indians or foreign sources involving foreign currency, the auditor has to verify the compliance of RBI regulations as well as the provisions of the Foreign Exchange Management Act, 1999 in this regard.

69. All transactions in the partners' capital account and drawings account have to be vouched for their correctness.

70. The auditor has to verify that the distribution of profit/loss is as per the terms of Partnership Deed. It may be noted that if any minor is admitted to the benefits of partnership, no loss should be apportioned to the share of minor.

71. If a partner dies/retires during the year, the partnership entity may prepare accounts up to the date of such death/retirement to ascertain the claim of heirs/retiring partner. In such event, the auditor has to verify the apportionment of the profit/loss for both the periods.

SPECIAL CONSIDERATIONS APPLICABLE TO A SOLE PROPRIETARY ENTITY

72. The audit of capital account of the sole proprietor poses considerable problems, as the capital account is generally maintained as a current account. Generally, the entries in the capital account are many, when compared with other forms of entities. The capital introduced by the proprietor in the entity may be in cash or in kind. The introduction of capital can take place at number of times, depending upon the need for the working capital in the entity. Similarly, the drawings are made for various personal expenses.

73. It may also be possible that the personal expenses of the proprietor are booked in the accounts of the business without appropriately reflecting them in those accounts.

74. Generally, internal control procedures are inadequate or absent in many sole proprietary entities. Hence, the auditor should be careful while examining the accounts of such entity. Though the auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities, however, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures. He should apply his professional judgment based on the knowledge of the business he has acquired to determine whether the expenditure recorded is in fact relevant and appropriate to the business and also all expenditures are recorded in the books of account.

75. The auditor should examine the nature of assets included in the balance sheet of the entity and verify whether such assets are relevant and appropriate to the nature of the business and recorded at fair value.

III.140 Auditing Pronouncements

76. Generally profits or losses are adjusted in the capital account or the drawings account of the proprietor, and reserve accounts are not maintained in case of sole proprietorship accounts. However, if fiscal laws require any reserve to be created for claiming any fiscal benefit, a reserve account with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve account may be provided in the same fiscal laws. In such event the auditor should examine the compliance with such laws.

77. Special Reserves created, if any, pursuant to fiscal laws, upon fulfillment of the terms of such reserves, have to be transferred to the capital account of the sole proprietor.

78. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

MANAGEMENT REPRESENTATIONS

79. The auditor should obtain from the management of the entity, a written representation on significant aspects of capital and reserves accounts, viz., that all the transactions in the capital and reserves have been recorded and recorded at correct values; that there are no unrecorded transactions in the capital and reserves accounts, that the year end balances (including any notes to the accounts in respect thereof) of the capital and reserves accounts have been appropriately presented and disclosed in accordance with applicable financial reporting framework, in the financial statements, that the management has complied with all the applicable rules and regulations while undertaking transactions relating to capital and reserves.

DOCUMENTATION

80. The auditor should maintain adequate working papers documenting significant aspects of audit such as:

- (a) the nature, timing, extent and results of the audit procedures performed to comply with Standards on Auditing and applicable legal and regulatory requirements;
- (b) the audit evidence obtained;
- (c) the conclusions reached on significant matters ; and
- (d) in relation to audit procedures designed to address identified risks of material misstatement, conclusions that are not otherwise readily determinable from the procedures performed or audit evidence obtained.

However, it may be noted that the extent of documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

Appendix A

Extracts from Counsel's opinion referred to in Para 22 – “Subscription in Cash and Kind”

“The ratio of Spargo's case is that if there is on the one side a bona-fide debt payable in money at once by the company (hereinafter called “debt”), and on the other side a bona-fide

liability to pay money on allotment of shares, so that if bank notes are handed from one side of the table to other in payment of calls, they may legitimately be handed back in payment of the debt. The law does not make it necessary that the formality should be gone through of the money being handed over be taken back again, and if the two demands are set off against each other the shares have been paid for in cash. This is still good law and on facts similar to those of Spargo's case it would be right for a company to show in its accounts the shares as having been allotted for cash.

It is the necessary implication of Section 227(1A)(f) that shares may be correctly stated to have been allotted for cash even though cash may not have been actually received in respect of such allotment If the Auditors find that the case is covered by the ratio of the decision in Spargo's case, no comment would be required from the Auditors and the statement in the Balance Sheet and other accounts that the shares were allotted for cash must be accepted as correct, regular and not misleading, although no cash had been actually received by the company.....

The function of Section 75(1) is merely to impose an obligation on the company to file a Return of the Allotments with the Registrar. Now, the expression "share allotted for cash" is an ambiguous expression. It may mean shares allotted for cash actually received by the Company, or it may mean shares allotted for cash not actually received but adjusted against a debt. In order that this ambiguity may be removed and the Registrar may know the precise factual position, Section 75(1)(a) requires that in the Return of Allotments to be filed with the Registrar shares should not be shown as having been allotted for cash if cash has not been actually received. This, however, does not prevent the company from stating in the Return that shares not shown in the Return as having been allotted for cash were in fact allowed against adjustment of a debt, and consequently such shares would be shown in the company's accounts as having been allotted for cash."

GUIDANCE NOTE ON AUDIT OF PAYMENT OF DIVIDEND*

The following is the text of the Guidance Note on Audit of Payment of Dividend issued by the Auditing and Assurance Standards Board of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.

1. Paragraph 2.1 of the “Preface to the Statements on Standard Auditing Practices¹” issued by the Institute of Chartered Accountants of India states that the “main function of the Auditing Practices Committee (APC)² is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs)³ so that these may be issued by the Council of the Institute”. Paragraph 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary”.
2. The Auditing and Assurance Standards Board has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Board. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Payment of Dividends, paragraphs 8.19 to 8.24 of the “Capital and Reserve” section of “Statement on Auditing Practices” shall stand withdrawn.⁴

Introduction

3. Guidance Note on Terms Used in the Financial Statements, issued by the Institute, defines dividend as “A distribution to shareholders out of profits or reserves available for this purpose”.
4. Dividend means a return on shares held in an entity and payable out of distributable surplus. The dividends, which are paid on winding up, are in fact distribution of the entity’s assets and not of profits, even if those assets include some profit earned on winding up of the entity. However, the proviso to section 205(3) of the aforementioned Act permits a company to

* Issued in August, 2005.

¹ The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I.A of this Handbook.

² Now known as the Auditing and assurance Standards Board (AASB).

³ Now known as Engagement Standards.

⁴ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

capitalise its profits by issuing fully paid bonus shares or paying up any amount being unpaid on shares held by its members. Further, under section 205(3) of the Companies Act, 1956, no dividend is payable otherwise than in cash.

5. Dividend includes any interim dividend. It may also be noted that in case of a company, provisions of section 205, 205A, 205C, 206, 206A and 207 of the Companies Act, 1956 apply to interim dividend as well.

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions as laid down in paragraph 6 of the Standard on Auditing 500, "Audit Evidence". In carrying out the audit of payment of dividends, the auditor's primary objective is to obtain sufficient appropriate audit evidence to satisfy himself that dividend has been declared and paid in accordance with the applicable provisions, if any, of the relevant laws and regulations applicable to the entity and that all the transactions relating to declaration and payment of dividend have been properly accounted for and disclosed. The auditor's scope of examination would, therefore, include:

- (a) verifying whether dividend has been declared out of distributable surplus after proper authorisation, as required under law;
- (b) evaluating the internal control system regarding procedure of preparation and issuance of dividend warrants /instructions for direct transfer of funds to the shareholders' accounts and also check the timeliness of dispatch of warrants and deposition of the dividend amount in the separate bank account, if any, maintained for this purpose;
- (c) examining compliance with the requirements of the relevant laws and regulations relating to payment of dividend, for example, mandatory transfer to a reserve fund or transfer to other funds, such as unclaimed dividend account., Investor Education and Protection Fund, etc., as applicable to the entity; and
- (d) examining the system for recording and appropriate disclosure of transactions during the year relating to payment of dividend.

Internal Control Evaluation

7. The auditor should ascertain whether the governing charter, for example, Articles of Association in case of a company, or any similar document of the entity, permits payment of dividend to the members by the entity. For example, a company formed under section 25 of the Companies Act, 1956 is prohibited under the said section itself from paying any dividend to its members.

8. The auditor should study and evaluate the system of internal control relating to payment of dividend to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects relating to payment of dividend:

- (a) whether all transactions in the dividend account have been authorised by the competent

III.144 Auditing Pronouncements

authority;

- (b) whether the registers containing the details of members and dividend have been properly maintained by the entity;
- (c) whether there is an effective system of segregation of duties in place. Special attention should be given to the segregation of the duties towards maintenance of shareholders' register, preparation of dividend warrants and maintenance of warrant dispatch register;
- (d) the internal control procedures with regard to preparation of dividend warrants and posting them to the members, or the instructions given for electronic transfer of funds or any other mode of payment of dividend to the members, and records maintained to record the details of unclaimed dividend. Separate records of unclaimed dividend should be maintained for each year's dividend/interim dividend;
- (e) the procedures for payment of unclaimed dividend and should satisfy himself that they are not paid without adequate safeguards being taken as to identification of the payee, checking of the payee's claim, etc.

In case, the above activities are outsourced, the auditor should evaluate the activities of the service organisation and if finds them significant, he should obtain sufficient information to understand the accounting and internal control systems of the service organisation and assess control risk at either the maximum or a lower level, as appropriate, if tests of control are performed. For detailed guidance in this respect, reference may be made to Standard on Auditing 402, "Audit Considerations Relating to an Entity Using a Service Organisation."

Verification

9. Verification of payment of dividend may be carried out by performing the following procedures:

- (a) examination of compliance with laws and regulations and such other relevant information having a bearing on payment of dividend; and
- (b) examination of the system of maintenance of records.

10. The auditor should verify the compliance with laws and regulations, provisions contained in the governing charter, e.g. Articles of Association in case of companies, bye-laws or rules and directions/instructions issued by any regulatory authority applicable to the entity and/or the terms of the banks/financial institutions which may lay down certain restrictions or conditions on declaration of dividend. For example:

- (a) In case of companies, the following conditions have to be complied with before declaration of dividend:
 - ◆ It has provided for depreciation for any previous financial year(s) which fall(s) after the commencement of the Companies (Amendment) Act, 1960 [section 205(1)] and

further that such depreciation has been computed in accordance with the requirements of section 350 and other provisions of section 205(2) of the Act

- ◆ It has provided for any losses incurred in any previous financial year(s) which fall(s) after the commencement of the Companies (Amendment) Act, 1960 [section 205(1)]
 - ◆ Where the company has declared dividend for any financial year out of the profits for that year, it has also transferred to a reserve such percentage (or a higher percentage) of profits as may be prescribed in the Companies (Transfer of Profits to Reserves) Rules, 1975 [section 205(2A)]
 - ◆ It has complied with the requirements of section 80A, dealing with redemption of irredeemable preference shares etc., of the Companies Act, 1956.
- (b) Under the Banking Regulation Act, 1949, dividend can not be paid without first writing off intangible assets and transferring certain percentage of profits to statutory reserves unless permitted by the Central Government to do so. Section 17 of the Banking Regulation Act, 1949 requires that a banking company incorporated in India must transfer twenty per cent of its annual profits to a reserve fund before any dividend is distributed unless a specific exemption has been obtained from the Central Government.
- (c) State Co-operative laws lay down that certain percentage of profits have to be transferred to various reserves and a minimum percentage of profit has to be paid as dividend.

11. The auditor has to verify that the dividend is declared only out of distributable surplus. For example, in case of a company, under section 205 of the Companies Act, 1956, dividends can be distributed out of profits for the year in which dividend is declared, accumulated profits of any preceding year or under any guarantee given by Central or any State Government.

12. The auditor should verify that a specific resolution for payment of dividend has been duly passed at the meeting of the Board or any similar authority. In case of interim dividend, the dividend declared by the Board of Directors or similar authority is final. In case of final dividend, the auditor should also verify that the recommendations of the Board have been approved by the members at the annual general meeting. It may, however, be noted that in case of companies, the members can reduce the amount of dividend or decide for non-payment of dividend but they can not increase the dividend recommended by the Board.

13. If the entity has non-voting shares and/or shares with variable rights and /or preference shares with various options like, cumulative, participatory, etc., the resolution declaring the dividend should also specify different rates of dividend on the shares having variable rights or preferential rights as to dividend. In such cases, the auditor has to verify that the dividend paid is in accordance with the terms of the resolution and also the resolution is in accordance with the terms attached to these shares.

14. Other laws and regulations, relating to payment of dividend, governing the entity may impose similar or other restrictions. The auditor has to be familiar with the laws and regulations

III.146 Auditing Pronouncements

governing the entity and verify whether these laws and regulations have been complied with. For example, the auditor has to examine the compliance with provisions of the Foreign Exchange Management Act, 1999 for the payment of dividend in foreign currency pursuant to issue of shares to non-residents and issue of ADR/GDR. **Appendix** to this Guidance Note contains relevant extracts of the provisions of various statutes having a bearing on the declaration and payment of dividend.

15. In case of a listed company, the auditor should also verify whether the provisions of the Listing Agreement as to declaration of dividend, e.g., prior intimation to the Stock Exchange about the Board meeting at which declaration/recommendation of dividend is to be considered, intimation to Stock Exchanges of all dividends and/or cash bonuses recommended or declared or the decision to pass any dividend or interest payment at the Board meeting, have been complied with or not.

16. The nature, timing and extent of substantive procedures to be performed by the auditor is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

17. The auditor should examine that the mandatory transfer of the amount specified to a separate fund, where so required by the relevant laws and regulations, have been made before payment of dividend.

18. The auditor has to verify that the dividend is paid in accordance with the terms prescribed in resolution by the Board/members.

19. The auditor should verify that the dividend warrants have been dispatched to the members within the time limit prescribed.

20. If an interim dividend is declared, the auditor has to verify whether the same is approved in a general meeting of the members and the provisions contained in the Articles of Association or bye-laws or other statutes governing the body corporate permit it to pay interim dividend. In case of statutory corporations and nationalised banks, the Board may be empowered to declare and pay the dividend and resolution by the members may not be necessary. In case of companies, the auditor should verify that the financial statements have been prepared and presented before the Board and the Board while considering the interim dividend, has taken into account the depreciation to be provided for the full year, profit to be transferred to reserves under Companies (Transfer of Profits to Reserves) Rules, 1975 and the dividend payable to preference shareholders.

21. If the laws and regulations applicable to the entity require it to deposit the amount of dividend, interim and/or final, in a separate bank account, the auditor has to verify whether such transfer of funds to the separate account has been made within the prescribed time limit. The auditor should also verify the compliance of law with regard to unclaimed dividend. For example, in case of companies, the dividend declared has to be deposited within prescribed period in a

separate bank account and if dividend is not claimed within such number of days, of such transfer, as may be specified by the Companies Act, 1956 or rules made thereunder and the amount remaining in the separate bank account has to be transferred to unpaid dividend account separately opened with any scheduled bank and the amount remaining in that account after the expiry of such period of opening such unpaid dividend account, as may be prescribed together with interest accrued thereon, if any, has to be transferred to Investor Education and Protection Fund Account established under the Companies Act, 1956. It may be noted, that within specified number of months prior to the transfer of unclaimed dividend to Investor Education & Protection Fund, the company has to give notice to individuals who have not claimed such dividend. If the auditor finds that the amounts required to be transferred as above have a material effect on the financial statements, and have not been properly reflected in the financial statements, the auditor should assess the impact of such non-compliance on his audit report.

22. The auditor should verify that adjustment, if any, made in the dividend payable, towards calls in arrears or any other sums due from members is in accordance with the terms of issue, laws and regulations applicable to the entity.

23. The auditor may verify the total amount of dividend transferred to a separate bank account is in agreement with the statement prepared by the body corporate reconciling the total dividend payable on shares in physical form, dematerialised form, and dividend withheld in respect of shares pending for registration of transfer and adjustments, if any, made for the calls in arrears and other dues from the members.

24. The listed companies are required to electronically transfer dividend to bank accounts of the shareholders, wherever Electronic Clearing Services (ECS) facility is available and the members/depositories furnish details of the respective bank accounts of the members and in respect of others, distribute the dividend through dividend warrants. In such cases, in addition to test checks for individual payments, the auditor should examine the overall reconciliation of the total payment made through electronic transfer and payment made through dividend warrants.

25. The auditor should verify that the dividend is paid:

- (a) (i) in respect of shares held in electronic form, to those persons whose details as on record date/book closure date are furnished by the depositories; and/or
- (ii) in respect of shares held in physical form, to the members whose names are appearing on the record date/ immediately after effecting the transfers submitted till the date of book closure; and
- (b) in respect of share warrants to the holders of share warrants.

26. The auditor should apply the analytical procedures before forming any overall conclusion so as to find out any material fluctuations and deviations from the relevant information that he has gained during the course of audit. Such analytical procedures may be regarding the changes in the shareholding pattern, dividend pay out ratio, ratio of gross dividend payable to the paid up

III.148 Auditing Pronouncements

share capital or ratio of net dividend payable with the gross dividend payable by the entity. In case of listed companies, the auditor may also review the minutes of the meetings of the Investors' Grievances Committee, wherever such Committee exists, to have an overview of the nature and number of complaints related to dividends as the same would provide the auditor an additional evidence as to the efficacy of the internal control system in relation to payment of dividend.

27. The auditor should verify that the total amount remaining in the unclaimed dividend account, for example, because of dispute about ownership on account of court cases etc., or the amount not claimed by shareholders, tallies with the schedule of unclaimed dividend for each year for which dividend remains unclaimed.

28. The auditor has to verify that in case the entity proposes to pay dividend out of its accumulated reserves, whether the same has been paid after complying with the statutory requirements, if any. For example, a company can pay dividend out of its accumulated reserves only after complying with the provisions of sub-section (3) of Section 205A of the Companies Act, 1956 and the Companies (Declaration of Dividend out of Profits) Rules, 1975. These Rules provide for the maximum amount that can be paid as dividend. In cases where the company declares dividend that is not in accordance with these Rules, the auditor must verify that the company has obtained prior approval from the Central Government for the same. Similar provisions, if any, in the laws applicable to other entities have to be complied with.

29. The auditor should also verify that:

- (a) If capital profits are distributed as dividend:
 - (i) the Articles or the bye-laws or other rules and regulations applicable to the entity, permit such distribution; and
 - (ii) it has been realised in cash; and
 - (iii) the Board or similar authority is satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than the book values so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.
- (b) Capital surplus arising on the revaluation of fixed assets is not directly or indirectly available for distribution as dividend.
- (c) Any reserve in the nature of capital reserve arising on acquisition of a business as a going concern or on amalgamation in the nature of purchase and Securities premium collected on the issue of securities can not be utilised for declaration of dividend.

Disclosure

30. Proposed dividend should be shown as appropriation of profit in the Profit and Loss

Account and as provision under “Provisions” in the Balance Sheet.

31. Unclaimed dividends should be shown in Balance Sheet under the head “Current Liabilities”.

32. In respect of companies, all arrears of cumulative preference dividends should be shown as a contingent liability.

Management Representation

33. The auditor should obtain representation from the management of the entity about the amount retained in unclaimed dividend account by reason of disputes pending in various courts of law and also that it has complied with all laws and regulations applicable to the provisioning and payment of dividend including transfers to Unclaimed Dividend Fund or any other fund such as Investors Education and Protection Fund, where so required and that the dividend has been paid to the persons entitled to it.

Documentation

34. The auditor’s working papers should contain the plan devised for verification of payment of dividend. Among other papers, he should maintain in his audit file, the management representations and any other relevant document, such as copy of the Board resolution authorising payment of dividend, etc. He should ensure that all significant matters that require the exercise of his professional judgment, together with the auditor’s conclusion thereon have been properly included in his working papers.

Appendix

Provisions of Certain Acts and Rules With Regard to Declaration and Payment of Dividend⁵

The Companies Act, 1956

205. Dividend to be Paid only out of Profits – (1) No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government:

Provided that –

⁵ The Acts and Rules specified in this Appendix are only illustrative in nature and are not meant to be exhaustive for the purposes of the laws dealing with the payment of dividend by different entities.

III.150 Auditing Pronouncements

- (a) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960 (65 of 1960) it shall, before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years;
- (b) if the company has incurred any loss in any previous financial year or years, which falls or fall after the commencement of the Companies (Amendment) Act, 1960 (65 of 1960) then, the amount of the loss or an amount which is equal to the amount provided for depreciation for that year or those years whichever is less, shall be set off against the profits of the company for the year for which dividend is proposed to be declared or paid or against the profits of the company for any previous financial year or years, arrived at in both cases after providing for depreciation in accordance with the provisions of sub-section (2) or against both;
- (c) the Central Government may, if it thinks necessary so to do in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation:

Provided further that it shall not be necessary for a company to provide for depreciation as aforesaid where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before the commencement of the Companies (Amendment) Act, 1960 (65 of 1960).

- (1A) The Board of directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.
- (1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend.
- (1C) The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as far as may be, also apply to any interim dividend.
- (2) For the purpose of sub-section (1), depreciation shall be provided either –
 - (a) to the extent specified in section 350; or
 - (b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent of the original cost thereof to the company by the specified period in respect of such asset; or
 - (c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five per cent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

- (d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or any rules made there under, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case:

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

(2A) Notwithstanding anything contained in sub-section (1), on and from the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), no dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2), except after the transfer to the reserves of the company of such percentage of its profits for that year, not exceeding ten per cent, as may be prescribed:

Provided that nothing in this sub-section shall be deemed to prohibit the voluntary transfer by a company of a higher percentage of its profits to the reserves in accordance with such rules as may be made by the Central Government in this behalf.

(2B) A company which fails to comply with the provisions of section 80A shall not, so long as such failure continues, declare any dividend on its equity shares.

- (3) No dividend shall be payable except in cash:

Provided that nothing in this sub-section shall be deemed to prohibit the capitalization of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount, for the time being unpaid, on any shares held by the members of the company.

(4) Nothing in this section shall be deemed to affect in any manner the operation of the section 208.

- (5) For the purposes of this section –

- (a) “specified period” in respect of any depreciable asset shall mean the number of years at the end of which at least ninety-five per cent of the original cost of that asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the Provisions of section 350;
- (b) any dividend payable in cash may be paid by cheque or warrant sent through the post directed to the registered address of the shareholder entitled to the payment of the dividend, or in the case of joint shareholders, to the registered address of that one of the joint shareholders which is first named on the register of members, or to such person and to such address as the shareholder or the joint shareholders may in writing direct.

205A. Unpaid dividend to be transferred to special dividend account—

(1) Where, after the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), a dividend has been declared by a company but has not been paid, or claimed, within thirty days from the date of the declaration, to any shareholder entitled to the payment of the dividend, the company shall, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed within the said period of thirty days to a special account to be opened by the company in that behalf in any scheduled bank, to be called “Unpaid Dividend Account of Company Limited/ Company (Private) Limited”.

Explanation: In this sub-section, the expression “dividend which remains unpaid” means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

(2) Where the whole or any part of any dividend, declared by a company before the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), remains unpaid at such commencement, the company shall within a period of six months from such commencement, transfer such unpaid amount to the account referred to in sub-section (1).

(3) Where, owing to inadequacy or absence of profits in any year, any company proposes to declare dividend out of the accumulated profits earned by the company in previous years and transferred by it to the reserves, such declaration of dividend shall not be made except in accordance with such rules as may be made by the Central Government in this behalf, and, where any such declaration is not in accordance with such rules, such declaration shall not be made except with the previous approval of the Central Government.

(4) If the default is made in transferring the total amount referred to in sub-section (1) or any part thereof to the unpaid dividend account of the concerned company, the company shall pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of twelve per cent per annum and the interest accruing on such amount shall ensure to the benefit of the members of the company, in proportion to the amount remaining unpaid to them.

(5) Any money transferred to the unpaid dividend account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the fund established under sub-section (1) of section 205C.

(6) The company shall, when making any transfer under sub-section (5) to the Fund established under section 205C any unpaid or unclaimed dividend, furnish to such authority or committee as the Central Government may appoint in this behalf a statement in the prescribed form setting forth in respect of all sums included in such transfer, the nature of the sums, the names and last known addresses of the persons entitled to receive the sum, the amount to

which each person is entitled and the nature of his claim thereto, and such other particulars as may be prescribed.

(7) The company shall be entitled to a receipt from the authority or committee under sub-section (4) of section 205C for any money transferred by it to the Fund and such a receipt shall be an effectual discharge of the company in respect thereof.

(8) If a company fails to comply with any of the requirements of this section, the company and every officer of the company who is in default, shall be punishable with fine which may extend to five thousand rupees for every day during which the failure continues.

205B. Payment of unpaid or unclaimed dividend— Any person claiming to be entitled to any money transferred under sub-section (5) of section 205A to the general revenue account of the Central Government, may apply to the Central Government for an order for payment of the money claimed; and the Central Government may, if satisfied, whether on a certificate by the company or otherwise, that such person is entitled to the whole or any part of the money claimed, make an order for the payment to that person of the sum due to him after taking such security from him as it may think fit:

Provided that nothing contained in this section shall apply to any person claiming to be entitled to any money transferred to the fund referred to in section 205C on and after the commencement of the Companies (Amendment) Act, 1999.

205C. Establishment of Investor Education and Protection Fund— (1) The Central Government shall establish a fund to be called the Investor Education and Protection Fund (hereafter in this section referred to as the “Fund”).

(2) There shall be credited to the Fund the following amounts, namely:

- (a) amounts in the unpaid dividend accounts of companies;
- (b) the application moneys received by companies for allotment of any securities and due for refund;
- (c) matured deposits with companies;
- (d) matured debentures with companies;
- (e) the interest accrued on the amounts referred to in clauses (a) to (d);
- (f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and
- (g) the interest or other income received out of the investments made from the Fund:

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

III.154 Auditing Pronouncements

Explanation: For the removal of doubts, it is hereby declared that no claims shall lie against the Fund or the company in respect of individual amounts which were unclaimed and unpaid for a period of seven years from the dates that they first became due for payment and no payment shall be made in respect of any such claims.

(3) The Fund shall be utilised for promotion of investor's awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

(4) The Central Government shall, by notification in the Official Gazette, specify an authority or committee, with such members as the Central Government may appoint, to administer the Fund, and maintain separate accounts and other relevant records in relation to the Fund in such form as may be prescribed in consultation with the Comptroller and Auditor – General of India.

(5) It shall be competent for the authority or committee appointed under sub-section (4) to spend moneys out of the Fund for carrying out the objects for which the Fund has been established.

206. Dividend not to be paid except to registered shareholders or to their order or to their bankers—(1) No dividend shall be paid by a company in respect of any share therein, except—

- (a) to the registered holder of such share or to his order or to his bankers; or
- (b) in case a share warrant has been issued in respect of the share in pursuance of section 114, to the bearer of such warrant or to his bankers.

(2) Nothing contained in sub-section (1) shall be deemed to require the bankers of a registered shareholder to make a separate application to the company for the payment of the dividend.

206A. Right to dividend, right shares and bonus shares to be held in abeyance pending registration of transfer of shares— Where any instrument of transfer of shares has been delivered to any company for registration and the transfer of such shares has not been registered by the company, it shall, notwithstanding anything contained in any other provisions of this Act,—

- (a) transfer the dividend in relation to such shares to the special account referred to in section 205A unless the company is authorised by the registered holder of such share in writing to pay such dividend to the transferee specified in such instrument of transfer; and
- (b) keep in abeyance in relation to such shares any offer of rights shares under clause (a) of sub-section (1) of section 81 and any issue of fully paid-up bonus shares in pursuance of sub-section (3) of section 205.

207. Penalty for failure to distribute dividends within thirty days – Where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within thirty days from the date of declaration, to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to a fine of one thousand rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues:

Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provisions in the following cases, namely:

- (a) where the dividend could not be paid by reason of the operation of any law;
- (b) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with;
- (c) where there is a dispute regarding the right to receive the dividend;
- (d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or
- (e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.

Companies (Transfer of Profits to Reserves) Rules, 1975

[GSR 426 (E), Dated 24-7-1975]

In exercise of the powers conferred by sub-section (2A) of section 205, read with clause (a) of subsection (1) of section 642, of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules, namely:

Short title

1. These rules may be called the Companies (Transfer of Profits to Reserves) Rules, 1975.

Percentage of profits to be transferred to reserves

2. No dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) of section 205 of the Act, except after the transfer to the reserves of the company of a percentage of its profits for that year as specified below:

- (i) where the dividend proposed exceeds 10 per cent but not 12.5 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 2.5 per cent of the current profits;
- (ii) where the dividend proposed exceeds 12.5 per cent but does not exceed 15 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5 per cent of the current profits;
- (iii) where the dividend proposed exceeds 15 per cent but does not exceed 20 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 7.5 per cent of the current profits; and
- (iv) where the dividend proposed exceeds 20 per cent of the paid-up capital, the amount to be transferred to reserves shall not be less than 10 per cent of the current profits.

Conditions governing voluntary transfer of a higher percentage

3. Nothing in rule 2 shall be deemed to prohibit the voluntary transfer by a company of a percentage higher than 10 per cent of its profits to its reserves for any financial year, so however, that:

- (i) Where a dividend is declared, -
 - (a) a minimum distribution sufficient for the maintenance of dividends to shareholders at a rate equal to the average of the rates at which dividends declared by it over the three years immediately preceding the financial year, or
 - (b) in a case where bonus shares have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividends to share holders at an

amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year, is ensured:

Provided that in a case where the net profits after tax are lower by 20 per cent or more than the average net profits after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution,

- (ii) where no dividend is declared, the amount proposed to be transferred to its reserves from the current profits shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

Penalty

4. If a company fails to comply with any of the provisions contained in these rules, the company and every officer of the company in default, shall be punishable with fine which may extend to five hundred rupees, and, where the contravention is a continuing one, with a further fine which may extend to fifty rupees for every day, after the first, during which such contravention continues.

Companies (Declaration of Dividend out of Reserves) Rules, 1975

[GSR No. 427 (E), Dated 24-7- 1975]

In exercise of the powers conferred by sub-section (3) of section 205A, read with clause (a) of sub-section (1) of section 642, of the Companies Act, 1956 (1 to 1956), the Central Government hereby makes the following rules, namely:

Short title

1. These rules may be called the Companies (Declaration of Dividend out of Reserves) Rules, 1975.

Declaration of dividend out of reserves

2. In the event of inadequacy or absence of profits in any year, dividend may be declared by a company for that year out of the accumulated profits earned by it in previous years and transferred by it to the reserves, subject to the conditions that -

- (i) the rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in the five years immediately preceding that year or ten per cent of its paid up capital, whichever is less;
- (ii) the total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves shall not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn shall first be utilised to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared; and

III.158 Auditing Pronouncements

- (iii) the balance of reserves after such drawal shall not fall below fifteen per cent of its paid-up share capital.

Explanation: For the purposes of this rule, “profits earned by a company in previous years and transferred by it to the reserves” shall mean the total amount of net profits after tax, transferred to reserves as at the beginning of the year for which the dividend is to be declared; and in computing the said amount, the appropriations out of the amount transferred from the Development Rebate Reserve [at the expiry of the period specified under the Income-tax Act, 1961 (43 of 1961)] shall be included and all items of Capital Reserves including reserves created by revaluation of assets shall be excluded.

Insurance Act, 1938

Restriction on dividends and bonuses

49. (1) No insurer, being an insurer specified in sub-clause (a) (ii) or sub-clause (b) of clause (9) of section 2, who carries on the business of life insurance or any other class or sub-class of insurance business to which section 13 applies, shall, for the purpose of declaring or paying any dividend to shareholders or any bonus to policy-holders or of making any payment in service of any debentures, utilize directly or indirectly any portion of the life insurance fund or of the fund of such other class or sub class of insurance business, as the case may be, except a surplus shown in the valuation balance-sheet in such form as may be specified by the regulations made by the Authority submitted to the Authority as part of the abstract referred to in section 15, as a result of an actuarial valuation of the assets and liabilities of the insurer; nor shall he increase such surplus by contributions out of any reserve fund or otherwise unless such contributions have been brought in as revenue through the revenue account applicable to that class or sub-class of insurance business on or before the date of valuation aforesaid, except when the reserve fund is made up solely of transfers from similar surpluses disclosed by valuations in respect of which returns have been submitted to the Authority under section 15 of this Act or to the Central Government under section 11 of the Indian Life Assurance Companies Act, 1912 (6 of 1912):

Provided that payments made out of any such surplus in service of any debentures shall not exceed fifty per-cent of such surplus including any payment by way of interest on the debentures, and interest paid on the debentures shall not exceed ten per-cent of any such surplus except when the interest paid on the debentures is offset against the interest credited to the fund or funds concerned in deciding the interest basis adopted in the valuation disclosing the aforesaid surplus:

Provided further that the share of any such surplus allocated to or reserved for the shareholders (including any amount for the payment of dividends guaranteed to them, whether by way of first charge or otherwise), shall not exceed such sums as may be specified by the Authority and such share shall in no case exceed ten per-cent of such surplus in case of participating policies and in other cases the whole thereof.

(2) For the purposes of sub-section (1), the actual amount of income-tax deducted at source during the period following the date as at which the last preceding valuation was made and preceding the date as at which the valuation in question is made may be added to such surplus after deducting an estimated amount for income-tax on such surplus, such addition and deduction being shown in an abstract of the report of the actuary referred to in sub-section (1) of section 13:

Declaration of interim bonuses

112. Notwithstanding anything to the contrary contained in this Act, an insurer carrying on the business of life insurance shall be at liberty to declare an interim bonus or bonuses to policy-holders whose policies mature for payment by reason of death or otherwise during the inter-valuation period on the recommendation of the investigating of actuary made at the last preceding valuation.

The Banking Regulation Act, 1949

15. Restrictions as to Payment of Dividend

(1) No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off.

(2) Notwithstanding anything to the contrary contained in sub-section (1) or in the Companies Act, 1956 (1 of 1956), a banking company may pay dividends on its shares without writing off-

- (i) the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;
- (ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;
- (iii) the bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

17. Reserve Fund

(1) Every banking company incorporated in India shall create a reserve fund and shall, out of the balance of profit of each year, as disclosed to the profit and loss account prepared under Section 29 and before any dividend is declared, transfer to the reserve fund a sum equivalent to not less than twenty per cent of such profit.

(1A) Notwithstanding anything contained in sub-section (1), the Central Government may, on the recommendation of the Reserve Bank and having regard to the adequacy of the paid-up capital

III.160 Auditing Pronouncements

and reserves of a banking company in relation to its deposit liabilities, declare by order in writing that the provisions of sub-section (1) shall not apply to the banking company for such period as may be specified in the order:

Provided that no such order shall be made unless, at the time it is made, the amount in the reserve fund under sub-section (1), together with the amount in the share premium account is not less than the paid-up capital of the banking company.

(2) Where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the Reserve Bank, explaining the circumstances relating to such appropriation:

Provided that the Reserve Bank may, in any particular case, extend the said period of twenty-one days by such period as it thinks fit or condone any delay in the making of such report.

The Regional Rural Banks Act, 1976

21. Disposal of profits— After making provisions for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and all other matters for which provision is, under law, necessary or which are usually provided for by banking companies, a Regional Rural Bank may, out of its net profits, declare a dividend.

The Multi-State Co-Operative Societies Act, 2002

62. Funds not to be divided by way of profit— (1) No part of the funds, other than net profits, of a multi-State co-operative society shall be divided by way of bonus or dividend or otherwise distributed among its members.

(2) The net profit of a multi-State co-operative society referred to in sub-section (1) in respect of a society earning profits shall be calculated by deducting from the gross profits for the year, all interest accrued and accruing in relation to amounts which are overdue, establishment charges, interest payable on loans and deposits, audit fees, working expenses including repairs, rent, taxes and depreciation, bonus payable to employees under the law relating to payment of bonus for the time being in force, and equalization fund for such bonus, provision for payment of income-tax and making approved donations under the Income-tax Act, 1961 (43 of 1961), development rebate, provision for development fund, bad debt fund, price fluctuation fund, dividend equalization fund, share capital redemption fund, investment fluctuation fund, provision for retirement benefits to employees, and after providing for or writing off bad debts and losses not adjusted against any fund created out of profit:

Provided that such society may add to the net profits for the year interest accrued in the preceding years, but actually recovered during the year:

Provided further that in the case of such multi-State co-operative societies, as do not have share capital, the surplus of income over expenditure shall not be treated as net profits and such surplus shall be dealt with in accordance with the bye-laws.

63. Disposal of net profits (1) A multi-State co-operative society shall, out of its net profits in any year.

- (a) transfer an amount not less than twenty-five per cent to the reserve fund;
 - (b) credit one per cent, to co-operative education fund maintained, by the National Co-operative Union of India Limited, New Delhi, in the manner as may be prescribed;
 - (c) transfer an amount not less than ten per cent, to a reserve fund for meeting unforeseen losses.
- (2) Subject to such conditions as may be prescribed, the balance of the net profits may be utilised for all or any of the following purposes, namely: -
- (a) payment of dividend to the members on their paid-up share capital at a rate not exceeding the prescribed limit;
 - (b) constitution of, or contribution to, such special funds including education funds, as may be specified in the bye-laws;
 - (c) donation of amounts not exceeding five per cent of the net profits for any purpose connected with the development of co-operative movement or charitable purpose as defined in Section 2 of the Charitable Endowments Act, 1890 (6 of 1890);
 - (d) payment of ex-gratia amount to employees of the multi-State co-operative society to the extent and in the manner specified in the bye-laws.

64. Investment of funds: A multi-State co-operative society may invest or deposit its funds—

- (a) in a co-operative bank, State co-operative bank, co-operative land development bank or Central co-operative bank; or
- (b) in any of the securities specified in Section 20 of the Indian Trusts Act, 1882 ; or
- (c) in the shares or securities of any other multi-State co-operative society or any co-operative society; or
- (d) in the shares, securities or assets of a subsidiary institution or any other institution; or
- (e) with any other bank; or
- (f) in such other mode as may be provided in the bye-laws.

Explanation: For the purposes of clause (e), “bank” means any banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949, and includes-

- (a) the State Bank of India constituted under the State Bank of India Act, 1955;
- (b) a subsidiary bank as defined in clause (k) of Section 2 of the State Bank of India (Subsidiary Banks) Act, 1959;

III.162 Auditing Pronouncements

- (c) a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) or a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980).

Multi-State Co-operative Societies Rules, 2002

24. Distribution of profit to members.

- (1) No part of the funds, other than net profits of a multi-State co-operative society shall be distributed by way of bonus or dividend or otherwise among its members.
- (2) Payment of dividend to the members on their paid-up share capital shall be as specified in the bye-laws.
- (3) The bye-laws of a multi-State co-operative society may provide for distribution of patronage bonus to its members in consonance with the transactions of a member with the society.
- (4) Every multi-State Co-operative society may also provide for in their bye-laws the subjects and purposes for which the reserve fund will be utilised.

GUIDANCE NOTE ON TAX AUDIT UNDER SECTION 44AB OF THE INCOME-TAX ACT, 1961

1. Terms, abbreviations used in this Guidance Note.

In this Guidance Note the following terms and abbreviations occur often in the text. A brief explanation of such terms and abbreviations is given below. Further, reference to a section without reference to the relevant Act means that the section has reference to the Income-tax Act, 1961.

(a)	Act	The Income-tax Act, 1961.
(b)	AS	Accounting Standards prescribed under the Companies Act, 2013 for company assesseees and prescribed by the Institute of Chartered Accountants of India for non company assesseees.
(c)	AS(IT)	Accounting Standards notified by the Central Government under section 145(2).
(d)	Assessee	As defined in section 2(7) of the Act.
(e)	Audit report	Any report submitted in Form No. 3CA/3CB along with the statement of particulars in Form No. 3CD.
(f)	Board	The Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963.
(g)	Circular	A circular or instructions issued by the Board under section 119(1) of the Act.
(h)	Form or Forms	Collectively refer to Forms 3CA, 3CB and 3CD.
(i)	ICAI/Institute	The Institute of Chartered Accountants of India.
(j)	Limited Liability Partnership (LLP)	As defined in the Limited Liability Partnership Act, 2008
(k)	Person	As defined in section 2(31) of the Act.
(l)	Previous year	As defined in section 3 of the Act.

III.164 Auditing Pronouncements

- (m) **Rules** The Income-tax Rules, 1962.
- (n) **Specified date** "Specified date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the due date for furnishing the return of income under sub-section (1) of section 139 of the Act.
- (o) **SA** Standards on Auditing
- (p) **STT** Securities transactions tax leviable under Chapter VII of the Finance (No.2) Act, 2004.
- (q) **Tax audit** The audit carried out under the provisions of section 44AB.
- (r) **Tax auditor** Auditor appointed by an assessee to carry out tax audit.

2. Introduction

2.1 The Act provides for audit of accounts and/or report/certificate of a chartered accountant in the following cases in respect of AY 2014-15:

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
1.	Assessee carrying on the business of growing and manufacturing tea/coffee/rubber claiming deduction under section 33AB.	33AB (2)	5AC	3AC
2.	Assessee carrying on business consisting of the prospecting for, or extraction or production of, petroleum or natural gas or both in India and in relation to which the Central Government has entered into an agreement for the purpose of deposit in Special Account/ Site Restoration Account under section 33ABA.	33ABA (2)	5AD	3AD

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
3.	Assessees other than companies or co-operative societies claiming amortisation of certain preliminary expenses under section 35D and assessee being Indian company or a non-corporate resident claiming deduction for expenditure on prospecting etc. for certain minerals under section 35E.	35D (4) and 35E (6)	6AB	3AE
4.	Assessees carrying on business or profession whose sales, turnover or gross receipts exceed Rs.1 Crore (Rs.25 lakhs in the case of profession) as per the provisions of section 44AB, and assessee who claim their income to be lower than the profits or gains deemed to be the profits and gains of their business under sections 44AD, 44AE, 44BB or 44BBB.	44AB	6G	3CA/ 3CB/ and 3CD
5.	Assessee being a non-resident (not being a company) or a foreign company receiving income by way of royalty or fees for technical services from Government or India concern as per the provisions of section 44DA.	44DA (2)	6GA	3CE

III.166 Auditing Pronouncements

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
6.	Every assessee who has effected slump sale in the previous year as per the provisions of section 50B.	50B (3)	6H	3CEA
7.	Every person who has entered into an 'International transaction or specified domestic transaction' as per the requirement of section 92E of the Act.	92E	10E	3CEB
8.	Assessee who have been ordered by the Assessing Officer with the previous approval of the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner under section 142(2A) to get their books of account audited having regard to the nature and complexity of the accounts, volume of accounts, doubts about the correctness of the accounts, multiplicity of transactions in the accounts or specialized nature of business activity of the assessee and the interests of the revenue.	142(2A)	14A	6B
9.	Assessee being a trust or institution claiming deduction u/s 11 & 12 as per the requirement of section 12A(b).	12A(1)(b)	17B	10B

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
10.	Assessee being any fund or trust or institution or any university or other educational institution or any hospital or other medical institution referred to in sub-clause (iv) or sub-clause (v) or sub-clause (vi) or sub-clause (via) of section 10(23C) claiming exemption under section 10(23C).	10(23C)(iv)/(v)/(vi)/(via)	16CC	10BB
11.	Assessee being electoral trust receiving voluntary contributions	13B	17CA(12)	10BC
12.	Assessee claiming deduction in respect of eligible businesses under sections 80 – IA or 80 – IB (except Multiplex Theatres/ Convention Centres/ hospitals in rural areas) and eligible undertakings/enterprises claiming deduction under section 80 – IC.	80-IA (7)/80-IB/ 80-IC and 80-IE	18BBB (1)	10CCB
13.	Assessee claiming deduction under section 80-ID in respect of the profits and gains derived from the business of hotels and convention centres in specified areas.	80-ID (3)(iv)	18DE(3)	10CCBBA
14.	Assessee claiming deduction under section 80-IB (11C) in respect of the profits and gains from the	80-IB(11C)	18DDA	10CCBD

III.168 Auditing Pronouncements

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
	business of operating and maintaining a hospital located anywhere in India other than the excluded area.			
15.	Assessee claiming deduction under section 80-IA (6) in respect of profits and gains of business of housing or other activities which are an integral part of a highway project.	80-IA (6)	18BBE (3)	10CCC
16.	Assessee, being scheduled banks owning an offshore banking unit in a Special Economic Zone and International financial services centre, for claiming deduction under Section 80LA in respect of specified incomes.	80LA (3)	19AE	10CCF
17.	Assessee, being Indian companies, claiming deduction under section 80JJAA, in respect of employment of new workmen.	80JJAA(2)(b)	19AB	10DA
18.	Assessee responsible for making the payment to a non resident	195(6)	37BB(1)(ii)(a)	15CB
19.	Assessee who has failed to deduct tax at source in accordance with the provisions of the Act, not be deemed as an assessee in default provided certain conditions are fulfilled and	201(1)	31ACB (1)	26A

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
	a certificate from an accountant to this effect is furnished in the format prescribed under section 201(1) of the Act.			
20.	Assessee who has failed to collect tax at source in accordance with the provisions of the Act, not be deemed as an assessee in default provided certain conditions are fulfilled and a certificate from an accountant to this effect is furnished in the format prescribed under section 206C(6A) of the Act.	206C (6A)	37J (1)	27BA
21.	Corporate assessee liable to pay Minimum Alternate tax under section 115JB of the Act, to furnish a report from an accountant certifying the computation of book profits.	115JB (4)	40B	29B
22.	Non-corporate assessee liable to pay Alternate Minimum tax under section 115JC of the Act, to furnish a report from an accountant certifying the computation of adjusted book profits.	115JC (3)	40BA	29C
23.	Assessee being a non-resident having a liaison office in India prepare and deliver a statement containing such particulars as may be prescribed.	285	114DA	49C

III.170 Auditing Pronouncements

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
24.	Manufacturer assessee deriving Profits and gains from an undertaking by the export of articles or things or computer software	10A(5)	16D	56F
25.	Corporate assessee being an amalgamated company to furnish certificate from the principal officer, duly verified by an accountant regarding achievement of the prescribed level of production and continuance of such level of production in subsequent years.	72A(2)(b)(iii)	9C(b)	62
26.	Assessee being Unit Trust of India, distributing income to its unit holders to furnish a statement giving details of amount so distributed to be verified by an accountant as required by section 115R(3A).	115R(3A)	12B(2)	63
27.	Assessee being a mutual fund, distributing income to its unit holders to furnish a statement giving details of amount so distributed to be verified by an accountant as required by section 115R(3A).	115R(3A)	12B(3)	63A
28.	Assessee being a venture capital company or a venture capital fund to furnish a statement giving details of the nature of income paid or credited	115U (2)	12C (2)	64

S. No.	Particulars of Report/ statement/ Certificates	Applicable Section of the Income-tax Act, 1961	Applicable Rule of Income-tax Rules, 1962	Form No.
	during the previous year and other relevant details to be verified by an accountant as per section 115U.			
29.	Assessee engaged in the business of operating qualifying ships having opted for computation of income from such business under the tonnage tax scheme contained in chapter XII G of the Act to furnish a report under section 115VW of the Act.	115VW(ii)	11T	66

2.2 The first edition of this Guidance Note was published in the year 1985 immediately after the introduction of tax audit provision to help members in discharging their responsibility in an efficient manner. In order to incorporate changes made by the amendments to the Finance Act, as well as judicial pronouncements, circulars etc., the said Guidance Note has been revised in the years 1989, 1998, 1999, 2005 and 2013. The sequence of certain significant events is as follows:

- (a) The Government had substituted revised Rule 6G and Forms 3CA, 3CB and 3CD in the Official Gazette on June 4, 1999, vide Notification No 10950/F.No. 153/74/98/TPL and omitted Forms No.3CC and 3CE.
- (b) These forms have been subsequently revised vide CBDT's Notification No. 280/2004 dated 16th November 2004.
- (c) Significant changes in the Form No.3CD were made in the year 2006 through a Notification No. 208/2006 dated 10th August, 2006 which notified the Income tax (Ninth Amendment) Rules, 2006.
- (d) Significant changes in the Form No.3CD were again made in the year 2014 through the Notification No. 33/2014 dated 25.07.2014 which notified the Income-tax (7th Amendment) Rules, 2014.

2.3 Form No. 3CD is quite comprehensive and covers generally all the items included in Form No. 6B prescribed for reporting under section 142(2A) and hence this Guidance Note

III.172 Auditing Pronouncements

would meet almost all the reporting requirements of audit under section 142(2A) also. However, if under section 142(2A), the Assessing Officer requires specific information, the same has to be given separately along with Form No. 6B. The Institute has published separate Guidance Notes for audit of Public Charitable Institutions under section 12A(b), Report under section 92E of the Act, Report under section 115JB of the Act and Report under section 115JC of the Act.

2.4 The tax audit was introduced by section 11 of the Finance Act, 1984, which inserted a new section 44AB with effect from 1st April, 1985 [Assessment Year 1985-86]. This section makes it obligatory for a person carrying on business to get his accounts audited by a chartered accountant, and to furnish by the 'specified date', the report in the prescribed form of such audit, if the total sales, turnover or gross receipts in business in the relevant previous year exceed or exceeds the prescribed limit (Rs. One Crore w.e.f. A.Y. 2013-14). For a professional, the provisions of tax audit become applicable, if his gross receipts in profession exceed the prescribed limit (Rs. Twenty five Lakhs w.e.f. A.Y. 2013-14) in the relevant previous year. As observed by the Finance Minister, while presenting the Union Budget for 1984-85, and as stated in the Memorandum explaining the provisions of the Finance Bill, 1984, the compulsory audit is intended to ensure proper maintenance of books of account and other records, in order to reflect the true income of the tax payer and to facilitate the administration of tax laws by a proper presentation of the accounts before the tax authorities. This would also save the time of the Assessing Officers considerably in carrying out the verification. The scope of section 44AB was enlarged to provide that audit under the section would be required in case of a person carrying on the business of the nature referred to in section 44AD or 44AE or 44AF (by the Finance Act 1997 w.e.f. assessment year 1998-99) or 44BB or 44BBB (by the Finance Act 2003 w.e.f. assessment year 2004-05), if such person claims that his income is lower than the amount of income deemed under these sections as presumptive income. Thereafter, Finance (No.2) Act, 2009 (w.e.f. AY 2011-12) enlarged the scope of section 44AD to encompass within its ambit the assessee covered by the provision of erstwhile section 44AF and hence, section 44AF has been omitted. While section 44AF dealt with assessee carrying on retail trade, the amended section 44AD covers all assessee carrying on eligible business except professionals as referred to in section 44AA(1), a person earning income in the nature of commission or brokerage, a person carrying on any agency business.

2.5 The *vires* of section 44AB has been upheld by Hon'ble Supreme Court in *T.D. Venkata Rao v. Union of India* [1999] 237 ITR 315 (SC). The Apex Court has made the following significant observations:

"Chartered Accountants, by reason of their training have special aptitude in the matter of audits. It is reasonable that they, who form a class by themselves, should be required to audit the accounts of businesses whose income (sic: turnover) exceeds Rs.40 lakhs* and professionals whose income (sic: gross

receipts) exceeds Rs.10 lakhs in any given year. There is no material on record and indeed in our view, there cannot be that an income-tax practitioner has the same expertise as chartered accountants in the matter of accounts. For the same reasons the challenge under article 19 must fail, and it must be pointed out that these income-tax practitioners are still entitled to be authorised representatives of assessees."**

**(increased to Rs. One Crore w.e.f. A.Y. 2013-14)*

*** (increased to Rs. Twenty Five Lakhs w.e.f. A.Y. 2013-14)*

3. Provisions of section 44AB

3.1 Section 44AB reads as under:

"Audit of accounts of certain persons carrying on business or profession".

44AB. *Every person, --*

- (a) *carrying on business shall, if his total sales, turnover or gross receipts, as the case may be, in business exceed or exceeds one crore rupees* in any previous year; or*
- (b) *carrying on profession shall, if his gross receipts in profession exceed twenty-five lakh rupees* in any previous year; or*
- (c) *carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AE or section 44BB or section 44BBB, as the case may be, and he has claimed his income to be lower than the profits or gains so deemed to be the profits and gains of his business, as the case may be, in any previous year; or*
- (d) *carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AD and he has claimed such income to be lower than the profits and gains so deemed to be the profits and gains of his business and his income exceeds the maximum amount which is not chargeable to income-tax in any previous year*

get his accounts of such previous year audited by an accountant before the specified date and furnish by that date the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed.

Provided that this section shall not apply to the person, who derives income of the nature referred to in section 44B or section 44BBA, on and from the 1st day of April, 1985 or, as the case may be, the date on which the relevant section came into force, whichever is later.

III.174 Auditing Pronouncements

Provided further that in a case where such person is required by or under any other law to get his accounts audited, it shall be sufficient compliance with the provisions of this section if such person gets the accounts of such business or profession audited under such law before the specified date and furnishes by that date the report of the audit as required under such other law and a further report by an accountant in the form prescribed under this section.

Explanation - For the purposes of this section, -

- (i) "accountant" shall have the same meaning as in the Explanation below sub-section (2) of section 288;*
- (ii) "specified date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the due date for furnishing the return of income under sub-section (1) of section 139*

** w.e.f. A.Y. 2013-14*

3.2 The Explanation below sub-section (2) of section 288 defines "accountant". Accordingly, "accountant" means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949), and includes, in relation to any State, any person who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State. Section 226 of the Companies Act, 1956 has been replaced by section 141 in the Companies Act, 2013 w.e.f 1.4.2014.

3.3 The above section stipulates that every person carrying on business or profession is required to get his accounts audited by a chartered accountant before the "specified date" and furnish by that date the report of such audit, if the total sales, turnover or gross receipts exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14) in the case of business and gross receipts exceed the prescribed limit (Presently Rs.25 lakhs w.e.f. A.Y. 2013-14) in the case of profession - vide clauses (a) and (b) of section 44AB.

3.4 Clause (c) of section 44AB, inserted by the Finance Act, 1997 and subsequently amended by the Finance Act, 2003 and Finance (No. 2) Act, 2009, provides that in the case of an assessee carrying on a business of the nature specified in sections 44AE, 44BB or 44BBB tax audit will be required, if he claims his income to be lower than the presumptive income deemed under the said sections even if his sales, turnover, or gross receipts does not exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14).

3.5 (1) Clause (d) of section 44AB, inserted by the Finance Act, 2009 w.e.f 1-4-2011 provides that in the case of an assessee carrying on a business of the nature specified in section 44AD, tax audit will be required, if he claims his income to be lower than the presumptive income deemed under the said section and such income exceeds the maximum amount not chargeable to income-tax (i.e. basic exemption limit). Section 44AD as amended by Finance Act, 2009 provides that notwithstanding anything to the contrary contained

in sections 28 to 43C, in the case of an eligible assessee engaged in an eligible business, a sum equal to eight per cent of the total turnover or gross receipts of the assessee in the previous year on account of such business or, as the case may be, a sum higher than the aforesaid sum claimed to have been earned by the eligible assessee, shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".

(2) Any deduction allowable under the provisions of sections 30 to 38 shall, for the purposes of sub-section (1), be deemed to have been already given full effect to and no further deduction under those sections shall be allowed :

Provided that where the eligible assessee is a firm, the salary and interest paid to its partners shall be deducted from the income computed under sub-section (1) subject to the conditions and limits specified in clause (b) of section 40.

(3) The written down value of any asset of an eligible business shall be deemed to have been calculated as if the eligible assessee had claimed and had been actually allowed the deduction in respect of the depreciation for each of the relevant assessment years.

(4) The provisions of Chapter XVII-C shall not apply to an eligible assessee in so far as they relate to the eligible business.

(5) Notwithstanding anything contained in the foregoing provisions of this section, an eligible assessee who claims that his profits and gains from the eligible business are lower than the profits and gains specified in sub-section (1) and whose total income exceeds the maximum amount which is not chargeable to income-tax, shall be required to keep and maintain such books of account and other documents as required under sub-section (2) of section 44AA and get them audited and furnish a report of such audit as required under section 44AB.

(6) The provisions of this section, notwithstanding anything contained in the foregoing provisions, shall not apply to—

- (i) a person carrying on profession as referred to in sub-section (1) of section 44AA;
- (ii) a person earning income in the nature of commission or brokerage; or
- (iii) a person carrying on any agency business.

Explanation.—For the purposes of this section,—

- (a) "eligible assessee" means,—
 - (i) an individual, Hindu undivided family or a partnership firm, who is a resident, but not a limited liability partnership firm as defined under clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009); and
 - (ii) who has not claimed deduction under any of the sections 10A, 10AA, 10B, 10BA or deduction under any provisions of Chapter VIA under the heading "C. - Deductions in respect of certain incomes" in the relevant assessment year.

III.176 Auditing Pronouncements

- (b) "eligible business" means,—
- (i) any business except the business of plying, hiring or leasing goods carriages referred to in section 44AE; and
 - (ii) whose total turnover or gross receipts in the previous year does not exceed an amount of one crore rupees.

3.6 Under the provisions of section 44AD, an eligible assessee can opt to be assessed on presumptive basis, so long as the sales, turnover or gross receipts from an eligible business do not exceed Rs.1 crore. Once the sales, turnover or gross receipts from any such eligible business(es) exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14), a tax audit will be required under clause (a) of section 44AB. The provisions of sections 44AA and 44AB shall not apply insofar as they relate to an eligible business as referred to in section 44AD and , the business of plying, hiring or leasing goods carriages as referred to in section 44AE. In computing the monetary limits under sections 44AA and 44AB, the sales, turnover or gross receipts, from the business in the said sections is to be excluded.

3.7 If a person is carrying on business(es), coming within the scope of sections 44AD, 44AE, 44BB or 44BBB but he exercises his option given under these sections to get his accounts audited under section 44AB, tax audit requirements would apply, in respect of such business(es) even if the turnover of such business(es) does not exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14). In the case of a person carrying on businesses covered by sections 44AD, 44AE, 44BB or 44BBB and opting for presumptive taxation, tax audit requirement would not apply in respect of such businesses. If such person is carrying on other business(es) not covered by presumptive taxation, tax audit requirements would apply in respect thereof, if the turnover of such business(es), other than the business(es) covered by presumptive taxation thereof, exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14).

3.8 The first proviso to section 44AB stipulates that this section will not be applicable to a person who derives income of the nature referred to in sections 44B or 44BBA. Accordingly, where the assessee is carrying on any one or more of the businesses specified in section 44B or 44BBA referred to in the first proviso to section 44AB, the sales/turnover/gross receipts from such businesses shall not be included in the total sales/turnover/gross receipts for determining the applicability of section 44AB.

3.9 The report of such audit, duly signed and verified by the chartered accountant is required to be given in such form and setting forth such particulars as prescribed by the Board. Rule 6G provides that such audit report and particulars should be given in Forms No. 3CA/3CB as may be applicable and the statement of particulars should be given in Form No.3CD.

3.10 A question may arise in the case of an assessee who is eligible to claim deductions under various sections like sections 80-IA, 80-IB or 80-IC etc., as to whether it will be

necessary for him to get separate audit reports/certificates under these sections in addition to an audit report under section 44AB. The requirement of section 44AB is a general requirement covering the overall position of the accounts of the assessee. This applies to the consolidated accounts of the assessee for the relevant previous year covering the results of all the units owned by the assessee whether situated at one place or at different places. Therefore, when the turnover of all the units put together exceed the prescribed limits, the assessee will have to get the audit report under section 44AB in the prescribed form and separate audit reports in the forms prescribed for different purposes like sections 80-IA, 80-IB or 80-IC etc. will have to be further obtained by the assessee to meet the specific requirements of the relevant sections.

4. 'Profession' and 'business' explained

4.1. The term "business" is defined in section 2(13) of the Act, as under:

"Business" includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.

The word 'business' is one of wide import and it means activity carried on continuously and systematically by a person by the application of his labour or skill with a view to earning an income. The expression "business" does not necessarily mean trade or manufacture only - *Barendra Prasad Ray v ITO [1981] 129 ITR 295 (SC)*.

4.2 Section 2(36) of the Act defines profession to include vocation. Profession is a word of wide import and includes "vocation" which is only a way of living. – *Additional CIT v. Ram Kripal Tripathi [1980] 125 ITR 408 (All)*.

4.3 Whether a particular activity can be classified as 'business' or 'profession' will depend on the facts and circumstances of each case. The expression "profession" involves the idea of an occupation requiring purely intellectual skill or manual skill controlled by the intellectual skill of the operator, as distinguished from an operation which is substantially the production or sale or arrangement for the production or sale of commodities. - *CIT Vs. Manmohan Das (Deceased) [1966] 59 ITR 699 (SC)*, *CIT v. Ram Kripal Tripathi [1980] 125 ITR 408 (All)*.

4.4 The following have been listed out as professions in section 44AA read with Rule 6F and other professions notified thereunder (Notifications No. 1620 SO-18(E) dated 12.1.77, No. 9102SO 2675 dated 25.09.1992 and No.116 SO 385(E), dated 4.5.2001):

- (i) Accountancy
- (ii) Architectural
- (iii) Authorised Representative
- (iv) Company Secretary
- (v) Engineering

III.178 Auditing Pronouncements

- (vi) Film Artists/Actors, Cameraman, Director including an assistant director; a music director, including an assistant music director, an art director, including an assistant art director; a dance director, including an assistant dance director; Singer, Story-writer, a screen-play writer, a dialogue writer; editor, , lyricist and dress designer .
- (vii) Interior Decoration
- (viii) Legal
- (ix) Medical
- (x) Technical Consultancy
- (xi) Information Technology. Attention is invited to *Notification No. 890(E)/2000* dated 26-9-2000.

4.5. The following activities have been held to be business :

- (i) Advertising agent
- (ii) Clearing, forwarding and shipping agents - *CIT v. Jeevanlal Lalloobhai & Co. [1994] 206 ITR 548 (Bom)*.
- (iii) Couriers
- (iv) Insurance agent
- (v) Nursing home
- (vi) Stock and share broking and dealing in shares and securities - *CIT v. Lallubhai Nagardas & Sons [1993] 204 ITR 93 (Bom)*.
- (vii) Travel agent.

5. Sales, turnover, gross receipts

5.1 It will be noted that the provision relating to tax audit applies to every person carrying on business, if his total sales, turnover or gross receipts in business exceed the prescribed limit (Rs.1 crore w.e.f. A.Y. 2013-14) and to a person carrying on a profession, if his gross receipts from profession exceed the prescribed limit (Rs.25 lakhs w.e.f A.Y. 2013-14) in any previous year. However, the term "sales", "turnover" or "gross receipts" are not defined in the Act, and therefore the meaning of the aforesaid terms has to be considered for the applicability of the section.

5.2 The Central Sales Tax Act, 1956 defines "Turnover" as follows:

"turnover" used in relation to any dealer liable to tax under this Act means the aggregate of the sale prices received and receivable by him in respect of sales of any goods in the course of inter-State trade or commerce made during any prescribed period and determined in accordance with the provisions of the Act and rules made there under.

Further, section 8A(1) of the said Act provides that in determining turnover, deduction of sales tax should be made from the aggregate of sales price.

5.3 The term "Turnover" has been defined under Section 2(91) of the Companies Act, 2013 as follows:

"2(91) "turnover" means the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year;"

5.4 In the "Guidance Note on Terms Used in Financial Statements" published by the Institute, the expression "Sales Turnover" (Item 15.01) has been defined as under:-

"The aggregate amount for which sales are effected or services rendered by an enterprise. The term 'gross turnover' and 'net turnover' (or 'gross sales' and 'net sales') are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts".

5.5 The Guide to Company Audit issued by the Institute in the year 1980, while discussing "sales", stated as follows:

"Total turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt with by the company and indicating the quantities of such sales for each class separately.

Note (i) The term 'turnover' would mean the total sales after deducting therefrom goods returned, price adjustments, trade discount and cancellation of bills for the period of audit, if any. Adjustments which do not relate to turnover should not be made e.g. writing off bad debts, royalty etc. Where excise duty is included in turnover, the corresponding amount should be distinctly shown as a debit item in the profit and loss account."

5.6 The "Statement on the Amendments to Schedule VI to the Companies Act, 1956" issued by the Institute (Page 14, 1976 edition)(replaced with Guidance Note on Revised Schedule VI of the Companies Act, 1956) while discussing the disclosure requirements relating to 'turnover' stated as follows:-

"As regards the value of turnover, a question which may arise is with reference to various extra and ancillary charges. The invoices may involve various extra and ancillary charges such as those relating to packing, freight, forwarding, interest, commission, etc. It is suggested that ordinarily the value of turnover should be disclosed exclusive of such ancillary and extra charges, except in those cases where because of the accounting system followed by the company, separate demarcation of such charges is not possible from the accounts or where the company's billing procedure involves a composite charge inclusive of various services rather than a separate charge for each service.

III.180 Auditing Pronouncements

In the case of invoices containing composite charges, it would not ordinarily be proper to attempt a demarcation of ancillary charges on a proportionate or estimated basis. For example, if a company makes a composite charge to its customer, inclusive of freight and despatch, the charge so made should accordingly be treated as part of the turnover for purpose of this section. It would not be proper to reduce the value of the turnover with reference to the approximate value of the service relating to freight and despatch. On the other hand, if the company makes a separate charge for freight and despatch and for other similar services, it would be quite proper to ignore such charges when computing the value of the turnover to be disclosed in the Profit and Loss Account. In other words, the disclosure may well be determined by reference to the company's invoicing and accounting policy and may thereby vary from company to company. For reasons of consistency as far as possible, a company should adhere to the same basic policy from year to year and if there is any change in the policy the effect of that change may need to be disclosed if it is material, so that a comparison of the turnover figures from year to year does not become misleading."

5.7 The Statement on the Companies (Auditors' Report) Order, 2003 issued by the Institute in April 2004, while discussing the term 'turnover' in paragraph 23 states `as follows:

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

5.8 Although, Schedule III of the Companies Act, 2013 has replaced the Revised Schedule VI of the Companies Act, 1956 in the year 2014, guidance given herein above with respect to meaning of the term "turnover" is still relevant.

5.9 The term 'turnover' for the purposes of this clause may be interpreted to mean the aggregate amount for which sales are effected or services rendered by an enterprise. If sales tax and excise duty are included in the sale price, no adjustment in respect thereof should be made for considering the quantum of turnover. Trade discounts can be deducted from sales but not the commission allowed to third parties. If, however, the Excise duty and / or sales tax recovered are credited separately to Excise duty or Sales tax Account (being separate accounts) and payments to the authority are debited in the same account, they would not be included in the turnover. However, sales of scrap shown separately under the heading 'miscellaneous income' will have to be included in turnover.

5.10 Considering that the words "Sales", "Turnover" and "Gross receipts" are commercial terms, they should be construed in accordance with the method of accounting regularly

employed by the assessee. Section 145(1) provides that income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" should be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. The method of accounting followed by the assessee is also relevant for the determination of sales, turnover or gross receipts in the light of the above discussion.

5.11 Applying the above generally accepted accounting principles, a few typical cases may be considered:

- (i) Discount allowed in the sales invoice will reduce the sale price and, therefore, the same can be deducted from the turnover.
- (ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. The same should not be deducted from the figure of turnover.
- (iii) Turnover discount is normally allowed to a customer if the sales made to him exceed a particular quantity. This being dependent on the turnover, as per trade practice, it is in the nature of trade discount and should be deducted from the figure of turnover even if the same is allowed at periodical intervals by separate credit notes.
- (iv) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount. If it is in the nature of commission on sales, the same cannot be deducted from the figure of turnover.
- (v) Price of goods returned should be deducted from the figure of turnover even if the returns are from the sales made in the earlier year/s.
- (vi) Sale proceeds of fixed assets would not form part of turnover since these are not held for resale.
- (vii) Sale proceeds of property held as investment property will not form part of turnover.
- (viii) Sale proceeds of any shares, securities, debentures, etc., held as investment will not form part of turnover. However if the shares, securities, debentures etc., are held as stock-in-trade, the sale proceeds thereof will form part of turnover.

5.12 (a) A question may also arise as to whether the sales by a commission agent or by a person on consignment basis forms part of the turnover of the commission agent and/or consignee as the case may be. In such cases, it will be necessary to find out, whether the property in the goods or all significant risks, reward of ownership of goods belongs to the commission agent or the consignee immediately before the transfer by him to third person. If the property in the goods or all significant risks and rewards of ownership of goods continue to belong to the principal, the relevant sale price shall not form part of the sales/turnover of the commission agent and/or the consignee as the case may be. If, however, the property in the goods, significant risks and reward of ownership belongs to the commission agent and/or the

III.182 Auditing Pronouncements

consignee, as the case may be, the sale price received/receivable by him shall form part of his sales/turnover.

(b) In this context, it would be useful to refer to the CBDT Circular No.452 dated 17th March, 1986, where the Board has clarified the question of applicability of section 44AB in the cases of Commission Agents, Arhatias, etc. The Circular is published in **Appendix I (Page no. 213)**.

5.13 Share brokers, on purchasing securities on behalf of their customers, do not get them transferred in their names but deliver them to the customers who get them transferred in their names. The same is true in case of sales also. The share broker holds the delivery merely on behalf of his customer. The property in goods does not get transferred to the share brokers. Only brokerage which is being accounted for in the books of account of share brokers should be taken into account for considering the limits for the purpose of section 44AB. However, in case of transactions entered into by share broker on his personal account, the sale value should also be taken into account for considering the limit for the purpose of section 44AB. The case of a sub-broker is not different from that of a share broker.

5.14 The turnover or gross receipts in respect of transactions in shares, securities and derivatives may be determined in the following manner.

- (a) **Speculative transaction:** A speculative transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. Thus, in a speculative transaction, the contract for sale or purchase which is entered into is not completed by giving or receiving delivery so as to result in the sale as per value of contract note. The contract is settled otherwise and squared up by paying out the difference which may be positive or negative. As such, in such transaction the difference amount is 'turnover'. In the case of an assessee undertaking speculative transactions there can be both positive and negative differences arising by settlement of various such contracts during the year. Each transaction resulting into whether a positive or negative difference is an independent transaction. Further, amount paid on account of negative difference paid is not related to the amount received on account of positive difference. In such transactions though the contract notes are issued for full value of the purchased or sold asset the entries in the books of account are made only for the differences. Accordingly, the aggregate of both positive and negative differences is to be considered as the turnover of such transactions for determining the liability to audit vide section 44AB.
- (b) **Derivatives, futures and options:** Such transactions are completed without the delivery of shares or securities. These are also squared up by payment of differences. The contract notes are issued for the full value of the asset purchased or sold but entries in the books of account are made only for the differences. The transactions may be squared up any time on or before the striking date. The buyer of the option pays the

premia. The turnover in such types of transactions is to be determined as follows:

- (i) The total of favourable and unfavourable differences shall be taken as turnover.
- (ii) Premium received on sale of options is also to be included in turnover.
- (iii) In respect of any reverse trades entered, the difference thereon, should also form part of the turnover.

- (c) **Delivery based transactions:** Where the transaction for the purchase or sale of any commodity including stocks and shares is delivery based whether intended or by default, the total value of the sales is to be considered as turnover.

5.15 (a) Further, an issue may arise whether such transactions of purchase or sale of stocks and shares undertaken by the assessee are in the course of business or as investment. The answer to this issue will depend on the facts and circumstances of each case taking into consideration the nature of the transaction, frequency and volume of transactions etc. For this, attention is invited to the following judgments where this issue has been considered.

- (i) *CIT v. P.K.N. and Co Ltd (1966) 60 ITR 65 (SC)*
- (ii) *Saroj Kumar Mazumdar v. CIT (1959) 37 ITR 242 (SC)*
- (iii) *CIT v. Sutlej Cotton Mills Supply Agency Ltd. (1975) 100 ITR 706 (SC)*
- (iv) *G. Venkataswami Naidu & Co. v. CIT (1959) 351TR 594 (SC)*

Further, CBDT Circular No.4/2007, dated: 15-6-2007-**Appendix II (Page no. 217)** may also be referred to.

(b) In case such transactions are for the purposes of investment and income/loss arising therefrom is to be computed under the head 'Capital Gains', then the value of such transaction is not to be included in sales or turnover for deciding the applicability of audit under section 44AB. However, in case such transactions are in the course of business, then the total of such sales are to be included in the sale, turnover or gross receipts as the case may be, of the assessee for determining the applicability of audit under section 44AB.

5.16 The term "gross receipts" is also not defined in the Act. It will include all receipts whether in cash or in kind arising from carrying on of the business which will normally be assessable as business income under the Act. Broadly speaking, the following items of income and/or receipts would be covered by the term "gross receipts in business":

- (i) Cash assistance (by whatever name called) received or receivable by any person against exports under any scheme of the Government of India;
- (ii) Any duty of customs or excise or service tax re-paid or repayable as drawback to any person against exports under the Customs and Central Excise Duties and Service tax Drawback Rules, 1995;
- (iii) The aggregate of gross income by way of interest received by the money lender;
- (iv) Commission, brokerage, service and other incidental charges received in the business

III.184 Auditing Pronouncements

of chit funds;

- (v) Reimbursement of expenses incurred (e.g. packing, forwarding, freight, insurance, travelling etc.) and if the same is credited to a separate account in the books, only the net surplus on this account should be added to the turnover for the purposes of Section 44AB;
- (vi) The net exchange rate difference on export sales during the year on the basis of the principle explained in (v) above will have to be added;
- (vii) Hire charges of cold storage;
- (viii) Liquidated damages;
- (ix) Insurance claims - except for fixed assets;
- (x) Sale proceeds of scrap, wastage etc. unless treated as part of sale or turnover, whether or not credited to miscellaneous income account;
- (xi) Gross receipts including lease rent in the business of operating lease;
- (xii) Finance income to reimburse and reward the lessor for his investment and services;
- (xiii) Hire charges and instalments received in the course of hire purchase;
- (xiv) Advance received and forfeited from customers.
- (xv) the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession

5.17 The following items would not form part of "gross receipts in business" for purposes of section 44AB.

- (i) Sale proceeds of fixed assets including advance forfeited, if any;
- (ii) Sale proceeds of assets held as investments;
- (iii) Rental income unless the same is assessable as business income;
- (iv) Dividends on shares except in the case of an assessee dealing in shares;
- (v) Income by way of interest unless assessable as business income;
- (vi) Reimbursement of customs duty and other charges collected by a clearing agent;
- (vii) In the case of a recruiting agent, the advertisement charges received by him by way of reimbursement of expenses incurred by him;
- (viii) In the case of a travelling agent, the amount received from the clients for payment to the airlines, railways etc. where such amounts are received by way of reimbursement of expenses incurred on behalf of the client. If, however, the travel agent is conducting a package tour and charges a consolidated sum for transportation, boarding and lodging and other facilities, then the amount received from the members of group tour should form part of gross receipts;

- (ix) In the case of an advertising agent, the amount of advertising charges recovered by him from his clients provided these are by way of reimbursement. But if the advertising agent books the advertisement space in bulk and recovers the charges from different clients, the amount received by him from the clients will not be the same as the charges paid by him and in such a case the amount recovered by him will form part of his gross receipts;
- (x) Share of profit of a partner of a firm in the total income of the firm excluded from his total income under section 10(2A) of the Income-tax Act;
- (xi) Write back of amounts payable to creditors and/or provisions for expenses or taxes no longer required.

5.18 Thus, the principle to be applied is that if the assessee is merely reimbursed for certain expenses incurred, the same will not form part of his gross receipts. But in the case of charges recovered, which are not by way of reimbursement of the actual expenses incurred, they will form part of his gross receipts.

5.19 In the case of a professional, the expression "gross receipts" in profession would include all receipts arising from carrying on of the profession. A question may, however, arise as to whether the out of pocket expenses received by him should form part of his gross receipts for purposes of this section. Normally, in the case of solicitors, advocates or chartered accountants, such out of pocket expenses received in advance are credited in a separate client's account and utilised for making payments for stamp duties, registration fees, counsel's fees, travelling expenses etc. on behalf of the clients. These amounts, if collected separately either in advance or otherwise, should not form part of the "gross receipts". If, however, such out of pocket expenses are not specifically collected but are included/collected by way of a consolidated fee, the whole of the amount so collected shall form part of gross receipts and no adjustment should be made in respect of actual expenses paid by the professional person for and/or on behalf of his clients out of the gross fees so collected. However, the amount received by way of advance for which services are yet to be rendered will not form part of the receipts, as such advances are the liabilities of the assessee and cannot be treated as his receipts till the services are rendered.

5.20 A question may arise in the case of an assessee carrying on business and at the same time engaged in a profession as to what are the limits applicable to him under section 44AB for getting the accounts audited. In such a case if his professional receipts are, say, rupees twenty seven lakhs but his total sales, turnover or gross receipts in business are, say, rupees seventy two lakhs, it will be necessary for him to get his accounts of the profession and also the accounts of the business audited because the gross receipts from the profession exceed the limit of rupees twenty five lakhs. If however, the professional receipts are, say, rupees twenty one lakhs and total sales turnover or gross receipts from business are, say, rupees eighty six lakhs it will not be necessary for him to get his accounts audited under the above section, because his gross receipts from the profession as well as total sales, turnover or

gross receipts from the business are below the prescribed limits.

5.21 It may, however, be noted that in cases where the assessee carries on more than one business activity, the results of all business activities should be clubbed together. In other words, the aggregate sales, turnover and/or gross receipts of all businesses carried on by an assessee would be taken into consideration in determining whether the prescribed limit (Presently Rs. 1 crore w.e.f. A.Y. 2013-14) as laid down in section 44AB has been exceeded or not. However, where the business is covered by section 44B or 44BBA turnover of such business shall be excluded. Similarly, where the business is covered by section 44AD or 44AE and the assessee opts to be assessed under the respective sections on presumptive basis, the turnover thereof shall be excluded. So far as a partnership firm is concerned, each firm is an independent assessee for purposes of Income-tax Act. Therefore, the figures of sales of each firm will have to be considered separately for purposes of determining whether or not the accounts of such firm are required to be audited for purposes of section 44AB.

5.22 It must also be understood that the issue whether the turnover exceeds the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14) in the case of business or the gross receipts exceed the prescribed limit (Presently Rs.25 lakhs w.e.f. A.Y. 2013-14) in the case of profession is to be determined in each year independent of the results obtained in the preceding year or years. Further, this section applies only if the turnover exceeds the prescribed limit according to the accounts maintained by the assessee. If the Assessing Officer wants the assessee to get his accounts audited in cases where the figures of turnover as appearing in the books of account of the assessee do not exceed the prescribed limits, he has no option but to pass an order under section 142(2A) directing the assessee to get his accounts audited from a chartered accountant as may be nominated by the Commissioner of Income-tax or the Chief Commissioner of Income-tax.

6. Liability to tax audit - Special cases

6.1 A question may arise in the case of an assessee whose income is not chargeable to income-tax by reason of a specific exemption contained in the law or otherwise, as to whether he is required to get his accounts audited and to furnish such report under section 44AB. Such cases may cover those assessee who are wholly outside the purview of income-tax law as well as those whose income is otherwise exempt under the Act. It is felt that neither section 44AB nor any other provisions of the Act stipulate exemption from the compulsory tax audit to any person whose income is exempt from tax. This section makes it mandatory for every person carrying on any business or profession to get his accounts audited where conditions laid down in the section are satisfied and to furnish the report of such audit in the prescribed form. A trust/association/institution carrying on business may enjoy exemptions as the case may be under sections 10(21), 10(23A), 10(23B) or section 10(23BB) or section 10(23C) or section 11. A co-operative society carrying on business may enjoy deduction under section 80P. Such institutions/associations of persons will have to get their accounts audited and to furnish such audit report for purposes of section 44AB if their turnover in business exceeds

the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14). But an agriculturist, who does not have any income under the head "Profits and gains of business or profession" chargeable to tax under the Act and who is not required to file any return under the said Act, need not get his accounts audited for purposes of section 44AB even though his total sales of agricultural products may exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14)

6.2 It may be appreciated that the object of audit under section 44AB is only to assist the Assessing Officer in computing the total income of an assessee in accordance with different provisions of the Act. Therefore, even if the income of a person is below the taxable limit laid down in the relevant Finance Act of a particular year, he will have to get his accounts audited and to furnish such report under section 44AB, if his turnover in business exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14).

6.3 The case of non-residents may be considered separately. Section 44AB does not make any distinction between a resident or non-resident. Therefore, a non-resident assessee is also required to get his accounts audited and to furnish such report under section 44AB if his turnover/sales/gross receipts exceed the prescribed limits. This audit, however, would be confined only to the Indian operations carried out by the non-resident assessee since he is chargeable to income-tax in India only in respect of income accruing or arising or received in India.

7. Specified date and tax audit

7.1 As per the recent developments, the tax audit report is required to be uploaded using digital signature of the tax auditor. A question may arise whether a tax auditor appointed under section 44AB can be held responsible if he does not complete the audit and if the tax audit report is not uploaded before the specified date. Answer to this question will depend on the facts and circumstances of the case. Normally, it is the professional duty of the chartered accountant to ensure that the audit accepted by him is completed before the due date. If there is any unreasonable delay on his part, he is answerable to the Institute if a complaint is made by the client. However, if the delay in the completion of audit is attributable to his client, the tax auditor cannot be held responsible. It is, therefore, necessary that no chartered accountant should accept audit assignments which he cannot complete within the above time frame. In this regard, reference may also be made to paragraph 12 of this Guidance Note.

8. Penalty

8.1. In order to ensure proper compliance with section 44AB, section 271B has been enacted which reads as under:-

"Failure to get accounts audited

271B. *If any person fails to get his accounts audited in respect of any previous year or years relevant to an assessment year or furnish a report of such audit as required under*

III.188 Auditing Pronouncements

section 44AB, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum equal to one-half per cent of the total sales, turnover or gross receipts, as the case may be, in business, or of the gross receipts in profession, in such previous year or years or a sum of one hundred fifty thousand rupees, whichever is less."

8.2. As such, the failure of a person, to get his accounts audited in respect of any previous year or furnish a copy of such report as required under section 44AB may attract a penalty equal to 0.5% of the total sales, turnover or gross receipts, or Rs.1.5 lakh whichever is less. However, in view of the specific provisions contained in section 273B, no penalty is imposable under section 271B on the assessee for the above failure if he proves that there was reasonable cause for the said failure. The onus of proving reasonable cause is on the assessee.

8.3. Some of the instances where Tribunals/Courts have accepted as "reasonable cause" are as follows:

- (a) Resignation of the tax auditor and consequent delay;
- (b) *Bona fide* interpretation of the term 'turnover' based on expert advice;
- (c) Death or physical inability of the partner in charge of the accounts;
- (d) Labour problems such as strike, lock out for a long period, etc.;
- (e) Loss of accounts because of fire, theft, etc. beyond the control of the assessee;
- (f) Non-availability of accounts on account of seizure;
- (g) Natural calamities, commotion, etc.

9. Tax auditor

9.1 The tax audit is to be carried out by an "accountant". The term "accountant" has been defined in sub-clause (i) of Explanation to section 44AB as under:

For the purposes of this section, -

- (i) "accountant" shall have the same meaning as in the Explanation below sub-section (2) of section 288".

The above-mentioned Explanation reads as under:

"Accountant" means a chartered accountant within the meaning of Chartered Accountants Act, 1949 (38 of 1949) and includes, in relation to any State, any person, who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State."

As stated earlier, section 226 of the Companies Act, 1956 has been replaced with section 141 in the Companies Act, 2013 with effect from 1.04.2014.

9.2 The proviso to section 44AB lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person gets the accounts of such business or profession audited under such other law before the specified date and furnishes by that date the report by an 'accountant' as required under section 44AB. It may be noted that after amendment by the Finance Act, 2001, tax audit can be carried out by an accountant only. Accordingly, in case of any assessee like a co-operative society where the accounts under the relevant law have been audited by a person other than a chartered accountant, the tax audit will have to be conducted by the 'accountant' as defined under section 44AB.

9.3. Though the section refers to the accounts being audited by an accountant which means a chartered accountant as defined above, the audit can also be done by a firm of chartered accountants. This has been a recognised practice under the Act. In such a case, it would be necessary to state the name of the partner who has signed the audit report on behalf of the firm. The member signing the report as a partner of a firm or in his individual capacity should give his membership number while registering himself in the e-filing portal.

9.4. Section 44AB stipulates that only Chartered Accountants should perform the tax audit. This section does not stipulate that only the statutory auditor appointed under the Companies Act or other similar Statute should perform the tax audit. As such the tax audit can be conducted either by the statutory auditor or by any other chartered accountant in full time practice.

9.5 It may be noted that the Council at its 242nd meeting has passed a resolution effective from 1st April 2005, that any member in part-time practice (namely, holding a certificate of practice and also engaging himself in any other business and/or occupation) is not entitled to perform attest functions including tax audit.

9.6 A question may arise in the case of a public sector company or any other company where the statutory auditor has not been appointed by the authorities concerned as to whether the tax auditor appointed under section 44AB can complete his audit without waiting for statutory audit report on the accounts audited by the statutory auditors. It may be noted that Form No. 3CA requires the tax auditor to enclose a copy of the audit report conducted by the statutory auditor or the auditor of the financial statements as the case may be. Where a statutory auditor has not been appointed by the authorities concerned or where the report of the statutory auditor is not available for whatever reasons, it will be possible for the tax auditor to give his report in Form No. 3CB and to certify the relevant particulars in Form No.3CD. This is particularly important in those cases where the assessee concerned has suffered losses in the relevant accounting year. It may, however, be noted that the tax auditor in such cases will have to conduct the financial audit as well in order to enable him to certify whether or not the accounts reported upon by him give a true and fair view of the state of affairs of the assessee whose accounts are audited by him under section 44AB.

9.7 Tax audit under section 44AB being a recurring audit assignment, for expressing professional opinion on the financial statements and the particulars, the member accepting the

III.190 Auditing Pronouncements

assignment should communicate with the member who had done tax audit in the earlier year as provided in the Chartered Accountants Act. When making the enquiry from the retiring auditor, the member accepting the assignment should find out whether there is any professional or other reasons why he should not accept the appointment. The professional reasons for not accepting the appointment include:

- ◆ Non-compliance of the provisions of sections 224 and 225 of the Companies Act as mentioned in *Code of Ethics issued by ICAI under Clause (9) of Part I of First Schedule to Chartered Accountants Act, 1949. Sections 224 and 225 have been replaced with section 139/142 and section 140 respectively in Companies Act, 2013.
- ◆ Non-payment of undisputed audit fees by auditees other than in case of sick units for carrying out the statutory audit under the Companies Act, 1956/2013 or various other statutes.
- ◆ Issuance of qualified report

9.8 In the case of a person whose accounts of the business or profession have been audited under any other law (i.e. a company, a co-operative society, etc. which is required to get the accounts audited under a Statute) it is not necessary to communicate with the statutory auditor if he had not done tax audit in the earlier year. Attention of the members is invited to the detailed discussion in the publication of ICAI, *"Code of Ethics" – **Appendix III (Page no. 220)**. Further, attention of members is invited to the Chapter- VII "Appointment of an Auditor in case of non-payment of undisputed fees" of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August, 2008- **Appendix IV (Page no. 226)**

**In view of the fact that with effect from 01.04.2014.the Companies Act, 1956 has been replaced with Companies Act, 2013, the "Code of Ethics" issued by ICAI is under revision. The members may refer the revised "Code of Ethics" as and when published for the above mentioned provisions.*

9.9 A chartered accountant should not accept the tax audit of a person to whom he is indebted for more than rupees ten thousand. Reference should be made to Chapter- X "Appointment of an auditor when he is indebted to a concern" of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August, 2008- **Appendix IV (Page no. 226)** whereby a member of the Institute shall be deemed to be guilty of professional misconduct if he accepts appointment as an auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding rupees ten thousand. For this purpose, the limit of Rs. 10,000/- shall be the aggregate amount in respect of the proprietor and/or the partner/s of the firm of chartered accountants.

9.10 The Council has issued a Guideline No.1-CA(7)/02/2008, dated 8th August, 2008 given in **Appendix IV (Page no. 226)** Chapter- IX "Appointment as Statutory auditor" states that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking/ Government

Company /Listed Company and other Public Company having turnover of Rs. 50 crores or more in a year and accepts any other work or assignment or service in regard to the same undertaking/company on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking/company.

9.11 The above restrictions shall apply in respect of fees for other work or service or assignment payable to the statutory auditors and their associate concerns put together.

9.12 As per the said notification, the term “other work(s)” or “service(s)” or “assignment(s)” shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include: -

- (i) audit under any other statute;
- (ii) certification work required to be done by the statutory auditors; and
- (iii) any representation before an authority.

9.13 Since the obligation for tax audit has been specified in section 44AB of the Income-tax Act, 1961, it will be considered as an audit under any other statute for the purpose of this notification and thus the above restriction shall not apply in respect of tax audit fees.

9.14 The tax auditor should obtain from the assessee a letter of appointment for conducting the audit as mentioned in section 44AB. It is advisable that such an appointment letter should be signed by the person competent to sign the return of income in terms of the provisions of section 140 of the Act. It would also be useful if the letter affirms that no other auditor was appointed to conduct the tax audit for the year for which the appointment is being made. The letter may also give the name and address of the tax auditor for the previous year, wherever relevant. This would give the necessary information to the incoming tax auditor to enable him to communicate with the previous auditor. The letter of appointment should also specify the remuneration of the tax auditor. SA-210, *Agreeing the Terms of Audit Engagement* issued by the ICAI requires that the auditor to agree with the terms of audit engagement with management or those charged with governance as appropriate. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of written agreement and shall include (a) The objective and scope of the audit of the financial statements; It should be specifically mentioned that the scope of audit is restricted to the provisions contained in section 44AB of the Income tax Act, 1961 and the Income-tax Rules, 1962. (b) The responsibilities of the auditor; (c) The responsibilities of management; (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and (e) Reference to the expected form and content of any reports to be issued by the auditor as per the provisions of Income-tax Act, 1961 and Income-tax Rule, 1962 along with a statement that there may be circumstances in which a report may differ from its expected form and content. In the interest of both client and auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any

III.192 Auditing Pronouncements

misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit and the extent of the auditor's responsibilities to the client. However, it may be noted that wherever an audit is to be conducted under a Statute, acknowledgement of the letter of the auditor by the client is considered to be sufficient compliance of SA-210. The tax auditor should get the statement of particulars, as required in the annexure to the audit report, authenticated by the assessee before he does the same.

9.15 The tax auditor is required to upload the tax audit report directly in the e-filing portal.

9.16 The appointment of the auditor for tax audit in the case of a company need not be made at the general meeting of the members. It can be made by the Board of Directors or even by any officer, if so authorised by the Board in this behalf. The appointment in the case of a firm or a proprietary concern can be made by a partner or the proprietor or a person authorised by the assessee. It is possible for the assessee to appoint two or more chartered accountants as joint auditors for carrying out the tax audit, in which case, the audit report will have to be signed by all the chartered accountants. In case of disagreement, they can give their reports separately. In this regard, attention is invited to Para 12 of the SA 299, *Responsibility of Joint Auditors* issued by ICAI reproduced below:

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

The responsibility of joint tax auditors will be the same as in the case of other audits e.g. audit under the Companies Act. For details relating to such responsibility, in the case of joint tax audit, reference may be made to SA 299, *Responsibility of Joint Auditors*.

9.17 The position of a tax auditor for conducting audit under section 44AB will be considered as an office of profit. Therefore, the provisions of section 314 of the Companies Act, 1956 will be attracted when a relative of a director is appointed as a tax auditor of the company, if the remuneration thereof exceeds the limits prescribed in the aforesaid section. The necessary formalities will be required to be complied with as required under section 314. It may be noted Section 314 of the Companies Act, 1956 has been replaced with section 188 of the Companies Act, 2013, w.e.f. 1.4.2014.

9.18 The Act does not prohibit a relative or an employee of the assessee being appointed as a tax auditor under section 44AB. It may, however, be noted that as per the decision of the Council (reported in the Code of Ethics under clause (4) of Part I of Second Schedule), a chartered accountant should not express his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest. It may be

noted that the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law, e.g. Section 228(4) of the Companies Act, 1956 and the Companies (Branch Audit Exemption) Rules, 1961 made thereunder. Therefore, an employee of an assessee or an employee of a concern under the same management cannot audit the accounts of an assessee under section 44AB. Relevant extracts from the *Code of Ethics published by ICAI are given in **Appendix V (Page no. 237)**

**In view of the fact that with effect from 01.04.2014, the Companies Act, 1956 has been replaced with Companies Act, 2013, the "Code of Ethics" issued by ICAI is under revision. The members may refer the revised "Code of Ethics" as and when published for the above mentioned provisions.*

9.19 A chartered accountant who is responsible for writing or maintenance of the books of account of the assessee should not audit such accounts. This principle will apply to the partner of such a member as well as to the firm in which he is a partner. In view of this, a chartered accountant who is responsible for writing or maintenance of the books of account or his partner or the firm in which he is a partner should not accept tax audit assignment under section 44AB in the case of such an assessee.

9.20 The audit of accounts of a professional firm of chartered accountants, under section 44AB cannot be conducted by any partner or employee of such firm.

9.21 A chartered accountant/firm of chartered accountants, who is appointed as tax consultant of the assessee, can conduct tax audit under section 44AB. But an internal auditor of the assessee cannot conduct tax audit if he is an employee of the assessee. The Council of ICAI in its 281st meeting held from 3rd to 5th October, 2008 decided that an internal auditor of an assessee, whether working with the organisation or independently practicing chartered accountant or a firm of chartered accountants, cannot be appointed as his tax auditor. The decision was made effective from 12-12-2008.

9.22 A question may arise whether an assessee can remove a tax auditor appointed under section 44AB. The answer depends upon the facts and circumstances of the case. It is, however, possible for the management to remove a tax auditor where there are valid grounds for such removal. This may arise where the tax auditor has delayed the submission of audit report under section 44AB for an unreasonable period and if it is found that there is no possibility of getting the audit report uploaded before the specified date. In such cases, the management may be justified in removing the tax auditor. However, the tax auditor cannot be removed on the ground that he has given an adverse audit report or the assessee has an apprehension that the tax auditor is likely to give an adverse audit report. If there is any unjustified removal of tax auditors, the Ethical Standards Board constituted by the Institute

III.194 Auditing Pronouncements

can intervene in such cases. No other chartered accountant should accept the audit assignment if the removal of his predecessor is not on valid grounds.

9.23 Before accepting a tax audit, the chartered accountant should take into consideration the ceiling on tax audit assignments fixed under the Chapter VI- Tax Audit assignments under Section 44AB of the Income-tax Act, 1961 of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August,2008 as amended by a decision of the Council taken in its 331st meeting held from 10.02.2014 to 12.02.2014 and its 333rd meeting held from 14.05.2014 to 16.05.2014.- **Appendix-IV (Page no. 226) .**

9.24 In view of the said Guidelines a member of the Institute in practice, shall be deemed to be guilty of professional misconduct if, he accepts more than 60 tax audit assignments relating to an assessment year or such other limit as may be prescribed by ICAI from time to time under section 44AB, whether in respect of a person whose accounts have been audited under any other law or a person who carries on business or profession but who is not required by or under any other law to get his accounts audited.

9.25 (a) As per the Council Guidelines No.1-CA(7)/02/2008, dated 8th August, 2008, audit of books of account of persons carrying on businesses covered by sections 44AD and 44AE, is not included in the aforesaid limit. The auditor is advised to maintain the details of the audits conducted by virtue of the provisions of section 44AD and 44AE separately in the format mentioned in Para 9.26.

(b) Furthermore, a clarification was issued for reckoning the “specified number of tax audit assignments” conducted under section 44AB of the Income-tax Act, 1961, the text of the clarification is reproduced below:

“Various statutes prevailing in India like DVAT, 2004 requires the assessee to furnish an audit report in a form duly signed and verified by such particulars as may be prescribed under section 44AB of the Income-tax Act, 1961 i.e. Form 3CB/3CD. This had lead to the doubts as to whether such audits would be included in the ceiling of “specified number of tax audit assignments”.

Considering the same, the Council at its 311th meeting held on 8th and 9th November, 2011 clarified that audit prescribed under any statute which requires the audit report in the form as prescribed under section 44AB of the Income-tax Act, shall not be considered for the purpose of reckoning the specified number of tax audit assignments if the turnover of the auditee is below the turnover limit specified in section 44AB of the Income-tax Act, 1961. For instance audit under section 44AD, audit under DVAT, 2004 (for turnover between 40 to 60 Lakhs) etc. will not be considered for inclusion in the present limit of 60 audits”*

**w.e.f 1.04.2014*

9.26 In case the member is a partner of a firm of chartered accountants in practice, the ceiling of 60 tax audit assignments shall be computed with reference to each of the partner in

the said firm. Where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the ceiling limit of 60 shall apply with reference to all the firms together in relation to such partner. Similarly, where any partner accepts one or more tax audit assignments in his individual capacity, the total number of such assignments under section 44AB which may be accepted by him whether directly in his individual capacity or as partner of the firm of chartered accountants in practice shall not exceed 45 tax audit assignments. If two members or firms of chartered accountants are appointed as joint tax auditors, then the assignment will have to be included in the case of both the members or firms separately. It has, however, been clarified that the audit of the head office and branch offices concerned shall be regarded as one tax audit assignment. Similarly, the audit of one or more branches of the same concern by one chartered accountant in practice shall be construed as only one tax audit assignment. In computing the specified number of tax audit assignments each year's audit would be taken as a separate assignment. Every chartered accountant in practice shall maintain a record of the tax audit assignments accepted by him in each financial year in the format prescribed by the Council. This format is reproduced in **Appendix VI (Page no. 242)**.

9.27 The Institute has recommended fees for professional services on the basis of time devoted by a chartered accountant and his assistants. The fees for tax audit assignment can be charged by a chartered accountant on the basis of the work involved in the assignment. It may be appreciated that no uniform fees can be recommended on the basis of turnover because an assessee having turnover of Rs.1 crore in a trading activity may have less transactions as compared to an assessee having the same turnover in a manufacturing activity. Similarly the transactions in a wholesale business will be less than the transactions in a retail business. The revised minimum recommended scale of fees recommended by the Committee of Capacity Building of CA Firms and small and medium Practitioners as on date is given in **Appendix VII (Page No. 243)**.

9.28 The chartered accountants should charge reasonable fees depending upon the responsibility involved under the revised forms and taking into consideration the work involved in tax audit assignment which has increased considerably consequent to the revision of the forms. It is necessary that members of the profession should also maintain reasonable standards of professional fees.

9.29 As mentioned in Paragraph 9.26 above, the audit of the head office and branch offices of an assessee shall be regarded as one tax audit assignment.

10. Accounting Standards

10.1. Recognizing the need to harmonize the diverse accounting policies and practices in use in India and keeping in view the International developments in the field of accounting, the Council of the Institute has issued Accounting Standards.

10.2. The legal recognition to the Accounting Standards formulated by the ICAI was granted in October 1998 with insertion of Section 211(3A), (3B), and (3C) in the Companies Act, 1956. As per Section 211(3C) of the Act, Accounting Standards issued by the ICAI may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS). As per the proviso to the section, till the notification of the Accounting Standards by the Government, the Accounting Standards issued by the ICAI are required to be followed by companies. In the year 2006, Accounting Standards 1 to 7 and 9 to 29 were notified by the Ministry of Corporate Affairs, Government of India, under the Companies (Accounting Standards) Rules, 2006 vide its notification dated December 7, 2006 in the Gazette of India. These were made effective in respect of accounting periods commencing on or after the publication of these Accounting Standards (i.e., December 7, 2006). As per the Companies (Accounting Standards) Rules, 2006, Companies are classified into two categories, i.e., Small and Medium Companies (SMCs) and Non-SMCs. The Companies Act, 2013 has replaced Companies Act, 1956. Section 133 of the Companies Act, 2013 provides for compliance to Accounting Standards. The existing Accounting Standards notified under Companies (Accounting Standards) Rules, 2006 would continue to be followed.

10.3 ICAI, keeping in view the fact that the Accounting Standards notified under Companies (Accounting Standards) Rules, 2006, will be applicable to the companies, announced the scheme for applicability of accounting standards issued by ICAI to non-companies. The criteria for classification non-corporate entities as decided by ICAI and companies under the Companies (Accounting Standards) Rules, 2006 is given in **Appendix-VIII (Page no. 254)**.

10.4 The Accounting Standards, issued by ICAI/notified under Companies (Accounting Standards) Rules, 2006 are for use in the presentation of general purpose financial statements which are issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and other statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public at large.

10.5. The Institute has so far issued thirty two definitive standards as follows:

- AS 1 Disclosure of Accounting Policies
- AS 2 Valuation of Inventories
- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occurring After the Balance Sheet Date.
- AS 5 Net Profit or Loss for the period, Prior Period items and changes in Accounting policies
- AS-6 Depreciation Accounting

- AS 7 Construction Contracts
- AS 8 (Withdrawn pursuant to AS 26 becoming mandatory) Accounting for Research and Development
- AS 9 Revenue Recognition
- AS10 Accounting for Fixed Assets
- AS11 The Effects of Changes in Foreign Exchange Rates
- AS12 Accounting for Government Grants
- AS13 Accounting for Investments
- AS14 Accounting for Amalgamations
- AS15 Employee Benefits
- AS16 Borrowing Costs
- AS 17 Segment Reporting
- AS 18 Related Party Disclosures
- AS 19 Leases
- AS 20 Earnings Per Share
- AS 21 Consolidated Financial Statements
- AS 22 Accounting for Taxes on Income
- AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
- AS 24 Discontinuing Operations
- AS 25 Interim Financial Reporting
- AS 26 Intangible Assets
- AS 27 Financial Reporting of Interests in Joint Ventures
- AS 28 Impairment of Assets
- AS 29 Provisions, Contingent Liabilities and Contingent Assets
- AS 30 Financial Instruments: Recognition and Measurement
- AS 31 Financial Instruments: Presentation
- AS 32 Financial Instruments: Disclosures

10.6 AS 30, AS 31 and AS 32 issued by the Institute of Chartered Accountants of India (ICAI) in 2007 have not yet been notified by the Government under Section 211(3C)/133 of the Companies Act, 1956/2013 respectively. In respect of the financial statements or other financial information the status of AS 30 as announced by the Council of the ICAI is as

III.198 Auditing Pronouncements

follows:

- (i) To the extent of accounting treatments covered by any of the existing notified accounting standards (for eg. AS 11, AS 13 etc) the existing accounting standards would continue to prevail over AS 30.
- (ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc), the prescribed regulatory requirements would continue to prevail over AS 30.
- (iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

10.7 The abovementioned clarifications would also be relevant to the existing AS 31, *Financial Instruments: Presentation* and AS 32, *Financial Instruments: Disclosures*

10.8 **Applicability of Accounting Standards and exemptions/ relaxations for Small and Medium Sized Enterprises**

It may be noted that certain exemptions/relaxations from the applicability of accounting standards have been given to Small and Medium Size Enterprise (SMEs). Accordingly, the Council has decided upon the following scheme which has come into effect in respect of accounting periods commencing on or after 1.4.2004.

- (1) For the purpose of applicability of Accounting Standards, enterprises are classified into three categories, viz., Level I, Level II and Level III. Level II and Level III enterprises are considered as SMEs.
- (2) Level I enterprises are required to comply fully with all the accounting standards.
- (3) It has been decided that no relaxation should be given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements are given. The exemptions/relaxations are decided to be provided by modifying the applicability portion of the relevant accounting standards. The applicability of AS and exemptions/relaxations thereof for SMEs are given in **Appendix VIII (Page no. 254)**.

10.9 AS also apply in respect of financial statements audited under section 44AB of the Income-tax Act, 1961. Accordingly, members should examine compliance with the mandatory accounting standards when conducting such audit.

10.10 AS apply in respect of commercial, industrial or business activities of an enterprise. In

the case of charitable or religious organisations, AS will not apply if all activities of such organisations are not of commercial, industrial or business nature (e.g. an activity of collecting donations and giving them to flood affected people). In other words, exclusion of an entity from the applicability of the AS would be permissible only if no part of the activity of such entity is commercial, industrial or business in nature. Even if a very small portion of the activities of an entity is considered to be commercial, industrial or business in nature, then it cannot claim exemption from the application of AS. The AS would apply to all its activities including those which are not commercial, industrial or business in nature.

10.11 The Companies Act, 2013, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 2013, or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view.

10.12 In this connection, it may be noted that sub-section (1) of section 129 of the Companies Act, 2013, provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III thereof. It also provides that items contained in such financial statements shall be in accordance with the accounting standards. Sub-section (5) of section 129 provides that without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

10.13 Section 2(2) of Companies Act, 2013 provides that accounting standards" means the standards of accounting or any addendum thereto for companies or class of companies referred to in section 133.

10.14 The 'Preface to the Statements of Accounting Standards', issued by the Institute, *inter alia*, states:

The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation.

III.200 Auditing Pronouncements

Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Statutes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, e.g., the Companies Act, 2013 (section 129), and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.'

10.15 While discharging their attest function, the members of the Institute may keep the following in mind with regard to the mandatory AS.

AS 1 Disclosure of Accounting Policies¹

In the case of a company, members should qualify their audit reports in case:

- (a) accounting policies required to be disclosed under Schedule VI or any other provisions of the Companies Act, 1956, have not been disclosed, or
- (b) accounts have not been prepared on accrual basis, or
- (c) the fundamental accounting assumptions of going concern and consistency have not been followed and this fact has not been disclosed in the financial statements, or
- (d) proper disclosures regarding changes in the accounting policies have not been made.
- (e) Accounting Standards referred to in section 211(3C) of the Companies Act, 1956 have not been followed.

10.16 Where a company has been given a specific exemption regarding any of the matters stated above, but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

10.17 In the case of an enterprise other than a company, members should qualify their audit reports in case AS issued, prescribed and made mandatory by the ICAI have not been followed.

10.18 Financial statements prepared on a basis other than accrual

With regard to the fundamental accounting assumption of accrual, the Council has made a specific announcement that in respect of (a) Sole proprietary concerns/individuals, (b) Partnership firms, (c) Societies registered under the Societies Registration Act, (d) Trusts, (e) Hindu undivided families and (f) Association of persons, the auditor should examine whether the financial statements have been prepared on accrual basis. In case where the statute

¹ As per the announcement of the Council 'accounting Standards 1,7,8,9 and 10 made mandatory' published in July 1990 issue of 'The Chartered Accountants'

governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand where there is no statutory requirement for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual', the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the AS which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable qualifications in his audit report accordingly.

10.19 Accounting Standards under taxation law

The Finance Act, 1995 substituted a new section 145 w.e.f. A.Y. 1997-98. The section deals with method of accounting and is reproduced below :-

"145. (1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

(2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assesseees or in respect of any class of income.

(3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting provided in sub-section (1) or accounting standards as notified under sub-section (2), have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in section 144."

10.20 Standards notified by Government - AS (IT)

In exercise of the powers conferred by section 145(2), the Central Government has by Notification No. S.O.69 (E), dated 25th January, 1996 notified two AS (IT). This notification came into force with effect from 1st day of April, 1996, and is accordingly applicable from assessment year 1997-98 and subsequent assessment years.

10.21 These AS (IT) are given below:

Accounting Standards to be followed by all assesseees following mercantile system of accounting:

A. Accounting Standard I relating to disclosure of accounting policies

1. All significant accounting policies adopted in the preparation and presentation of financial statements shall be disclosed.
2. The disclosure of the significant accounting policies shall form part of the

III.202 Auditing Pronouncements

financial statements and the significant accounting policies shall normally be disclosed in one place.

3. *Any change in an accounting policy which has a material effect in the previous year or in the years subsequent to the previous years shall be disclosed. The impact of, and the adjustments resulting from such change, if material, shall be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact shall be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the previous year but which is reasonably expected to have a material effect in any year subsequent to the previous year, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted.*

4. *Accounting policies adopted by an assessee should be such so as to represent a true and fair view of the state of affairs of the business, profession or vocation in the financial statements prepared and presented on the basis of such accounting policies. For this purpose, the major considerations governing the selection and application of accounting policies are the following, namely:*

- (i) Prudence - Provisions should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information;*
- (ii) Substance over form - The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form;*
- (iii) Materiality - Financial statements should disclose all material items, the knowledge of which might influence the decisions of the user of the financial statements.*

5. *If the fundamental accounting assumptions relating to going concern, Consistency and Accrual are followed in financial statements, specific disclosure in respect of such assumptions is not required. If a fundamental accounting assumption is not followed, such fact shall be disclosed.*

6. *For the purposes of paragraphs (1) to (5), the expressions, -*

- (a) "Accounting policies" means the specific accounting principles and the methods of applying those principles adopted by the assessee in the preparation and presentation of financial statements;*
- (b) "Accrual" refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they*

relate;

- (c) "Consistency" refers to the assumption that accounting policies are consistent from one period to another;
- (d) "Financial statements" means any statement to provide information about the financial position, performance and changes in the financial position of an assessee and includes balance sheet, profit and loss account and other statements and explanatory notes forming part thereof;
- (e) "Going concern" refers to the assumption that the assessee has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

B. Accounting Standard II relating to disclosure of prior period and extraordinary items and changes in accounting policies:

1. Prior period items shall be separately disclosed in the profit and loss account in the previous year together with their nature and amount in a manner so that their impact on profit or loss in the previous year can be perceived.
2. Extraordinary items of the enterprise during the previous year shall be disclosed in the profit and loss account as part of taxable income. The nature and amount of each such item shall be separately disclosed in a manner so that their relative significance and effect on the operating results of the previous year can be perceived.
3. A change in an accounting policy shall be made only if the adoption of a different accounting policy is required by statute or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements by an assessee.
4. Any change in an accounting policy which has a material effect shall be disclosed. The impact of, and the adjustments resulting from such change, if material, shall be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact shall be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the previous year but which is reasonably expected to have a material effect in years subsequent to the previous years, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted.
5. A change in an accounting estimate that has a material effect in the previous year shall be disclosed and quantified. Any change in an accounting estimate which is reasonably expected to have a material effect in years subsequent to the previous year shall also be disclosed.

III.204 Auditing Pronouncements

6. *If a question arises as to whether a change is a change in accounting policy or a change in an accounting estimate, such a question shall be referred to the Board for decision.*

7. *For the purposes of paragraphs (1) to (6), the expressions:*

- (a) *“Accounting estimate” means an estimate made for the purpose of preparation of financial statements which is based on the circumstances existing at the time when the financial statements are prepared;*
- (b) *“Accounting policies” means the specific accounting principles and the method of applying those principles adopted by the assessee in the preparation and presentation of financial statements;*
- (c) *“Extraordinary items” means gains or losses which arise from events or transactions which are distinct from the ordinary activities of the business and which are both material and expected not to recur frequently or regularly. Extraordinary items include material adjustments necessitated by circumstances which though related to the years preceding the previous years are determined in the previous year;*
Provided that income or expenses arising from the ordinary activities of the business or profession or vocation of an assessee, though abnormal in amount or infrequent in occurrence, shall not qualify as extraordinary items;
- (d) *“Financial statements” means any statement to provide information about the financial position, performance and changes in the financial position of an assessee and includes balance sheet, profit and loss account and other statements and explanatory notes forming part thereof;*
- (e) *“Prior period items” means material charges or credits which arise in the previous year as a result of errors or omissions in the preparation of the financial statements of one or more previous years.*

Provided that the charge or credit arising on the outcome of a contingency, which at the time of occurrence could not be estimated accurately shall not constitute the correction of an error but a change in estimate and such an item shall not be treated as a prior period item.

10.22 The above Accounting Standards are to be followed by all assessees following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

10.23 Implications of non-compliance with the AS and AS (IT)

As mentioned earlier, AS are applicable to tax audit also when the tax auditor performs the attest function, i.e., report on whether the accounts are true and fair. Therefore, in case of

non-compliance with the AS, the chartered accountant should make appropriate qualifications/disclosures in the audit report. However, such qualifications/disclosures may or may not have any impact on the computation of total income for the purpose of the Act. Similarly, section 145 provides that the AS (IT) notified under that section should be followed by the assessee to whom they are made applicable. It should be noted that the tax auditor auditing accounts under section 44AB is not computing the income but is - (a) reporting on accounts, and (b) reporting on the relevant information furnished in Form No. 3CD. Form No. 3CD vide clause 11(d) requires reporting of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss. Further, it may be noted that there is no material difference between AS (IT)-1 and AS (IT)-2 notified by the Government and the corresponding AS-1 and AS-5 of the ICAI respectively.

11. Audit Procedures

11.1 In the case of an audit, the tax auditor is required to express his opinion as to whether the financial statements give a true and fair view of the state of affairs of the assessee in the case of the balance sheet and in the case of the profit and loss account/ income and expenditure account, of the profit/loss or income/expenditure. As regards the statement of particulars to be annexed to the audit report, he is required to give his opinion as to whether the particulars are true and correct. In giving his report the tax auditor will have to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require, considering the contents of the audit report. He will have to conduct the audit by applying the generally accepted auditing procedures which are applicable for any other audit. He should use his professional judgment to apply the technique of audit sampling in accordance with the principles enunciated in SA 530 (Revised) "*Audit Sampling*" depending on the nature and volume of transactions, the materiality involved and the internal control procedures followed by the assessee. He would also be well advised to refer to the other Standards on Auditing (SAs) as may be relevant, issued by ICAI, as well as the "Guidance Note on Audit Reports and Certificates for Special Purposes". If the statutory auditor of a person is also appointed to undertake tax audit, it is advisable to carry out both the audits concurrently.

11.2 Section 227/143 of the Companies Act 1956/2013 gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. No such powers are given to the tax auditor appointed under section 44AB. Attention is invited to SA 210, *Agreeing the Terms of Audit Engagements*. The Standard requires an auditor to establish whether the pre-conditions for an audit are present so as to accept or continue an audit engagement. As per para 6(b) (iii) the auditor is required to obtain agreement of management that it acknowledges and understands its responsibilities to provide the auditor with (a) access to all information of which the management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters, (b) additional information that the auditor may request the management for the

III.206 Auditing Pronouncements

purpose of the audit and (c) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. Moreover, since the appointment of the tax auditor is made by assessee, it will be in the interest of the assessee to furnish all the information and explanations and produce books of account and records required by the tax auditor. If, however, after agreeing to the terms of the engagement, the assessee subsequently refuses to produce any particular record or to give any specific information or explanation in relation to the reporting requirement under section 44AB, the tax auditor should see the impact thereof from the perspective of "management integrity" vis-a-vis overall assessment of risk of misstatements in accordance with under SA 315, *Identifying and Assessing the risks of material misstatement through understanding the entity and its environment* and consequently on his/her opinion for reporting in clause (3) of Form No.3CA or Clause (5) of Form No. 3CB as the case may be.

11.3 The audit report given under section 44AB is to assist the income-tax department to assess the correct income of the assessee. In order that the tax auditor may be in a position to explain any question which may arise later on, it is necessary that he should keep necessary working papers about the evidence on which he has relied upon while conducting the audit and also maintain all his necessary working papers. Such working papers should include his notes on the following, amongst other matters:

- (a) work done while conducting the audit and by whom;
- (b) explanations and information given to him during the course of the audit and by whom;
- (c) decision on the various points taken;
- (d) the judicial pronouncements relied upon by him while making the audit report; and
- (e) certificates issued by the client/management letters.

11.4 The requirements of documentation are applicable in respect of tax audit conducted by chartered accountants. For this purpose attention is also invited to SA 230, *Audit Documentation*, which provides that the tax auditor should prepare documentation that provides a sufficient and appropriate record of the basis for the auditor's report and evidence that the audit was planned and performed in accordance with SA's and applicable legal and regulatory requirements..

11.5 If the accounts of the business or profession of a person have been audited under any other law by the statutory auditor(s), it is not necessary for the tax auditor appointed under section 44AB to conduct the audit once again in the matter of expression of "true and fair view" of the state of affairs of the entity and of its profit/loss for the period covered by the audit. However, the said section envisages the certification of the particulars in the prescribed form on which the tax auditor has to express his opinion as to whether these are 'true and correct'. In other words, where an audit has already been conducted and the opinion of the auditor has been expressed on the accounts, it would not be necessary to repeat the entire exercise to express similar opinion all over again. The tax auditor has only to annex a copy of the audited accounts and the auditor's report and other documents forming part of these

accounts to his report and verify the particulars in the prescribed form for expressing his opinion as to whether these are true and correct.

11.6 Just in case of the conduct of a statutory audit for the purpose of expression of the auditor's opinion as to whether the financial statements depict a 'true and fair' view, the statutory auditor applies audit sampling, in case of tax audits also the tax auditor may apply audit sampling techniques as prescribed in SA 530, *Audit Sampling* on the information provided by the assessee to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.. The extent of check undertaken would have to be indicated by the tax auditor in his working papers and audit notes. The tax auditor would be well advised to so design his tax audit programme as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

11.7 Where the assessee has been subjected to an internal audit and the tax auditor decides to use the work of the internal auditor for the purpose of the tax audit under section 44AB, the latter's procedures would be guided by the principles laid down in Standard on Auditing (SA) 610, *Using the Work of Internal Auditors*.

11.8 Audit procedures applicable to a person whose accounts of the business or profession have been audited under any other law will apply as well to a person who carries on business or profession but who is not required by or under any other law to get his accounts audited. In order to express his opinion on the accounts of a person belonging to the latter category the tax auditor should apply the same tests and checks as he would have applied in the conduct of audit of the former category. In case the relevant vouchers for the expenditure and payments made by a non-corporate entity are not available, it will be necessary for the tax auditor to call for any other evidence in support of such expenditure and payments. The entity should be advised to maintain vouchers/records in evidence of transactions to avoid a qualification/observation* in the matter by the tax auditors. The qualification in respect of this matter would, in the normal course, be necessary in case the vouchers or other evidence required to be maintained are not produced in evidence of the income/expenditure or assets/liabilities. The entity should be encouraged to maintain office vouchers with the recipient's signatures for the amounts reimbursed on account of expenditure like local conveyance etc., for which other supporting evidence is not possible to obtain. It would also be advisable to give appropriate notes on accounts in the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited. These may include disclosure regarding method of accounting and practices consistently and regularly followed, and whether a change in such matters or practice has been made during the year, notwithstanding the fact that such disclosures are required to be made in Form No.3CD.

* Attention of the members is invited to the principles laid out in SA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

11.9 The ICAI had pursuant to the issuance of the Revised SA 700, *Forming an Opinion and*

III.208 Auditing Pronouncements

Reporting on Financial Statements, prescribed a revised format of the auditor's report on financial statements, which has been made effective in respect of audits of financial statements for periods beginning on or after 1st April 2012. Since Form No. 3CA and Form No. 3CB are required to be filed online in a preset form and the same are not in line with the requirements of SA 700, there is no specifically allocated field for providing information relating to the respective responsibilities of the assessee and the tax auditor as required in terms of the principles laid out in SA 700. However, having regard to the importance of these respective responsibility paragraphs from the perspective of the readers of the tax audit report, it is suggested that these respective responsibility paragraphs relating can be provided in the space provided for giving observations, etc., under clause (3) of Form No.3CA or Clause (5) of Form No.3CB as the case may be.

11.10 The illustrative Assessee's responsibility paragraph and Tax Auditor's responsibility paragraphs in respect of Form No.3CB are given hereunder. The same may be suitably reworded to meet the situation envisaged in Form No.3CA.

“Assessee's Responsibility for the Financial Statements and the Statement of Particulars in Form 3CD

1. *The assessee is responsible for the preparation of the aforesaid financial statements that give a true and fair view of the financial position and financial performance (if applicable) in accordance with the applicable Accounting Standards issued by the Institute of Chartered Accountants of India². This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.*
2. *The assessee is also responsible for the preparation of the statement of particulars required to be furnished under section 44AB of the Income-tax Act, 1961 annexed herewith in Form No. 3CD read with Rule 6G(1)(b) of Income Tax Rules, 1962 that give true and correct particulars as per the provisions of the Income-tax Act, 1961 read with Rules, Notifications, circulars etc that are to be included in the Statement.*

Tax Auditor's Responsibility

3. *My/ Our responsibility is to express an opinion on these financial statements based on my/our audit. I/We have conducted this audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.*

² (in case of the assessee being a Company, the reference would be to the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956/ section 133 of the Companies Act, 2013)

4. *An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purposes of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.*
5. *I/We believe that the audit evidence I/we have obtained is sufficient and appropriate to provide a basis for my/our audit opinion.*
6. *I/We are also responsible for verifying the statement of particulars required to be furnished under section 44AB of the Income-tax Act, 1961 annexed herewith in Form No. 3CD read with Rule 6G (1) (b) of Income-tax Rules, 1962. I/ We have conducted my/our verification of the statement in accordance with Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961, issued by the Institute of Chartered Accountants of India."*

11.11 In this regard, attention of the members is also invited to the Announcement regarding "Applicability of SA 700, forming an opinion and reporting on financial statements, to formats of auditor's reports prescribed under various laws and/ or regulations" (22.08.2013), issued by ICAI, given in **Appendix IX (Page No. 266)**.

12. Professional misconduct

12.1 It may be noted that when any question relating to professional misconduct in connection with tax audit arises, the tax auditor would be liable under the Chartered Accountants Act and the ICAI's disciplinary jurisdiction will prevail in this regard.

13. Audit Report

13.1 Section 44AB requires the tax auditor to submit the audit report in the prescribed form and setting forth the prescribed particulars. Sub-rule (1) of Rule 6G provides that the report of audit of accounts of a person required to be furnished under section 44AB shall -

- (a) in the case of a person who carries on business or profession and who is required by or under any other law to get his accounts audited, be in Form No. 3CA;
- (b) in the case of a person who carries on business or profession, but not being a person referred to in clause (a), in Form No. 3CB.

13.2 Sub-rule (2) of Rule 6G further provides that the particulars which are required to be

III.210 Auditing Pronouncements

furnished under section 44AB shall be in Form No. 3CD.

13.3 It may be noted that the audit report in Form No.3CB is in two parts. The first part requires the tax auditor to give his opinion as to whether or not the accounts audited by him give a true and fair view:

- (i) in the case of the balance sheet, of the state of affairs as at the last date of the accounting year.
- (ii) in the case of the profit and loss account, of the profit or loss of the assessee for the relevant accounting year.

13.4 The second part of the report states that the statement of particulars required to be furnished under section 44AB is annexed to the audit report in Form No. 3CD. The tax auditor is required to give his opinion whether the prescribed particulars furnished by the assessee are true and correct, subject to observations and qualifications, if any.

13.5 In paragraph 3 of Form No. 3CB the auditor has to report that the financial statements audited by him give a 'true and fair' view. With regard to the term "true and fair view" the auditor is advised to consider in the Framework for Preparation and Presentation of Financial Statements as also paragraph 12, 13, 14 and 27 of SA 700 (Revised), *Forming an opinion and reporting on Financial Statements*. Attention of the members is drawn to Para 5 of SA 200, *Overall Objectives of the Independent Auditor* reproduced below:

"5. As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive."

13.6 The requirement in paragraph 3 of Form No.3CA and paragraph 5 of Form No.3CB relating to particulars in Form No.3CD is that the auditor should report that these particulars in Form No.3CD are "true and correct". The terminology "true and fair" is widely understood though not defined even under the Companies Act, 1956/2013. On the other hand, the words "true and correct" lay emphasis on factual accuracy of the information. In this context reference is invited to AS-1 and AS(IT)-I relating to disclosure of accounting policies. These standards recognise that the major considerations governing the selection and application of accounting policies are (i) prudence, (ii) substance over form and (iii) materiality. Therefore, while giving particulars in Form No.3CD these aspects should be kept in view. In particular, considering the nature of particulars to be given in Form No.3CD, the aspect of materiality

should be considered. In other words, particulars should be given in the respect of material items and the auditors should assess factual correctness relating to these particulars. Attention of the members, in this context is, however, also drawn to Para 51 of "Framework for Assurance Engagements" reproduced below:

"51. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- *The use of selective testing.*
- *The inherent limitations of internal control.*
- *The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.*
- *The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.*
- *In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria."*

13.7 In the case of a person whose accounts of the business or profession have been audited under any other law, it is not required for the tax auditor appointed under section 44AB to give his opinion, as to whether or not the accounts give a true and fair view as indicated herein above. It would only be necessary for him to annex a copy of the audited accounts as well as a copy of the audit report given by the statutory auditor with his report in Form No. 3CA along with Form No.3CD.

13.8 In the case of a person who carries on business and also renders professional services but who is not required by or under any other law to get his accounts audited, report should be given in Form No. 3CB. The statement of particulars should be given in Form No. 3CD.

13.9 In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the expression "proper books of account" should mean, the books of original entry and other books of account required to be maintained to record all the transactions of the assessee in the same manner, as in the case of a person whose accounts of the business or profession have been audited under any other law. Although, books of account have not yet been prescribed for a person who carries on business or profession (except under Section 44AA for certain categories of profession), the tax auditor should examine whether such books are maintained by the assessee to provide the information and the basis required to prepare the balance sheet and the profit and loss account correctly in the formats recommended in **Appendices XV (Page no. 278) and XVI (Page no. 286)** of this Guidance Note.

13.10 In case the accounts of a person who carries on business or profession are being audited for the first time, the tax auditor should ensure compliance with SA 510 (Revised), *Initial Audit Engagements- Opening Balance*.

III.212 Auditing Pronouncements

13.11 In certain cases, members are called upon to report on the accounts reopened and revised by the board of directors. The accounts of a company once adopted at its annual general meeting should not normally be re-opened and revised. The Institute and the Ministry of Corporate Affairs have affirmed this position. In case of revision, the audit report should be given in the manner as required by the Institute in SA-560 (Revised), *Subsequent Events*. The Ministry of Corporate Affairs had also clarified that accounts can be revised to comply with technical requirements. It may be pointed out that report under section 44AB should not normally be revised. However, sometimes a member may be required to revise his tax audit report on grounds such as:

- (i) revision of accounts of a company after its adoption in annual general meeting.
- (ii) change of law e.g., retrospective amendment.
- (iii) change in interpretation, e.g. CBDT Circular, judgements, etc.

13.12 In case where a member is called upon to report on the revised accounts, then he must mention in the revised report that the said report is a revised report and a reference should be made to the earlier report also. In the revised report, reasons for revising the report should also be mentioned.

13.13 In the case of companies having their accounting year which is different from the financial year, accounts of the financial year are required to be prepared and audited. The audit report shall be in Form 3CB. The above position has also been clarified by the CBDT in its Circular No, 561 dated 22.5.1990. The Circular is reproduced in **Appendix X (Page no 268)**.

14. Form No. 3CA

14.1 This form is to be used in a case where the accounts of the business or profession of a person have been audited under any other law. The first part of the report refers to the fact that the statutory audit of the assessee was conducted by a chartered accountant or any other auditor in pursuance of the provisions of the relevant Act, and the copy of the audit report along with the audited profit and loss account and balance sheet and the documents declared by the relevant Act to be part of or annexed to the profit and loss account and balance sheet, are annexed to the report in Form No. 3CA. In a case where the tax auditor carrying out the audit under section 44AB is different from the statutory auditor, a reference should be made to the name of such statutory auditor. In case the statutory auditor is carrying out the audit under section 44AB, the fact that he has carried out the statutory audit under the relevant Act should be stated. Attention of the members in this context is invited to SA 600 *Using the work of Another Auditor*.

14.2 The next paragraph states that the statement of particulars required to be furnished under section 44AB is annexed with the particulars in Form No. 3CD. The tax auditor has to further state that, in his opinion and to the best of his information and according to

examination of books of account including other relevant documents and explanations given to him, the particulars given in the said Form No.3CD and the annexure thereto are true and correct subject to the observations/qualifications, if any.

14.3 The auditor is required to examine not only the books of accounts but also other relevant documents directly related to transactions reflected in the books of accounts like original purchase invoice, copy of bank statements, bills, vouchers, various agreements/contracts or any other document on the basis of which preliminary entries are passed in the books of accounts.

14.4 Attention is also drawn to the definition of 'document' as per section 2(22AA) of the Act which is as under:

"document" includes an electronic record as defined in clause (t) of sub-section (1) of section 2 of the Information Technology Act, 2000 (21 of 2000).

Section 2(1)(t) of the Information Technology Act, 2000 as referred above is reproduced below:

"electronic record" means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche.

The definition of term "document" is an inclusive definition and includes within its ambit documents other than those considered as electronic record as per section 2(1)(t) of the Information Technology Act, 2000. The above definition can also be relied when reporting under clause 11(c) of Form No. 3CD discussed later in this Guidance Note.

14.5 Where any of the requirements in this form is answered in negative or with qualification, the report shall state the reasons thereof. The tax auditor should state this qualification in the audit report so that the same becomes a comprehensive report and the user of the audited statement of particulars can realize the impact of such qualifications.

14.6 It is possible that in the case of a person whose accounts of the business or profession have been audited under any other law, which has branches at various places, the branch accounts might have been audited by branch auditors under the statute. If the audit under section 44AB is also carried out by the same branch auditors or other chartered accountants, they should submit the report in Form No. 3CA to the management or the principal tax auditor appointed for the head office under Section 44AB. Attention in this regard is drawn to SA 600, *Using the Work of Another Auditor* which discusses the procedures in this regard as well as the principal tax auditor's responsibility in relation to his use of the work of the branch auditor. The principal tax auditor should submit his consolidated report on the registered office/head office and branch accounts and report in his tax audit report as his observation in paragraph 3 of Form No. 3CA as under:

"I/We have taken into consideration the audit report and the audited statements of accounts, and particulars received from the auditors, duly appointed under the relevant law, of the branches not audited by me/us".

III.214 Auditing Pronouncements

14.7 Item No. 4 of the notes to Form No. 3CA requires that the person, who signs this audit report, shall indicate reference of his membership No./certificate of practice number/authority under which he is entitled to sign this report. No separate certificate of practice number is allotted by ICAI. As such, where a chartered accountant acts as a tax auditor he should give his membership number with ICAI while registering himself in the e-filing portal. In case, the e-filing utility of Form No. 3CA requires the mention of the Firm Registration number and the name of the firm on whose behalf the member has conducted audit, the same should invariably be provided by the tax auditor.

14.8 An assessee may have one or more branches outside India. The accounts of such branches are normally audited by the professional accountants overseas. The results of such branches are also incorporated in the consolidated accounts prepared in this country. In the case of foreign branches, the relevant information in respect of such branches as is required by Form No. 3CD, may be obtained by the tax auditor in India from the assessee who should obtain the same from the overseas auditor who had audited the accounts of such foreign branches. The tax auditor in India while certifying the information in Form No. 3CD may rely upon the information obtained by him from the overseas auditor and while submitting his consolidated report in Form No. 3CD, he should specifically point out the following in his audit report in paragraph 3 of Form No. 3CA as his observation:-

“I/We have taken into consideration the audit report and the audited statements of accounts, and particulars received from the auditors, appointed under the relevant law, of the overseas branches not audited by me/us”.

If the assessee is unable to obtain relevant information in respect of the overseas branches duly certified by the overseas auditor, the relevant facts should be suitably disclosed and reported upon.

14.9 Where the tax auditor is unable to obtain the required information in respect of branches situated in India or outside India then the fact should be suitably disclosed along with its impact on the Auditor's opinion on the particulars furnished in Form No. 3CD, as an observation in clause (3) of Form No. 3CA. Reference is drawn to SA 705, *Modifications to the opinion in the Independent Auditor's report*.

15. Form No. 3CB

15.1 In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the audit report has to be given in Form No. 3CB. Form No. 3CB consists of five paragraphs.

15.2 The tax auditor has to state whether he has examined the balance sheet as on a particular relevant date and the profit and loss account/income and expenditure account for that period. Further, such a balance sheet and the profit and loss account must be attached with the audit report.

15.3 The tax auditor has to certify that the balance sheet and the profit and loss account/income and expenditure account are in agreement with the books of account maintained at the head office and branches. Also, he has to mention the total number of branches.

15.4 He has to report his observations, comments, discrepancies or inconsistencies, if any. Subject to the above observations, comments, discrepancies, inconsistencies he has to state whether:

- (a) he has obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purposes of the audit;
- (b) in his opinion proper books of account have been kept by the head office and branches of the assessee so far as appears from his examination of the books;
- (c) in his opinion and to the best of his information and according to the explanations given to him the said accounts, read with notes thereon, if any, give a true and fair view;
 - (i) in the case of the balance sheet of the state of the affairs of the assessee as at 31st March, _____ and
 - (ii) in the case of the profit and loss account/income and expenditure account of the profit/loss or surplus/deficit of the assessee for the year ended on that date.

15.5 Under clause (a) of paragraph 3 of Form No.3CB, the tax auditor has to report his “observations/comments/ discrepancies/inconsistencies,” if any. The expression “Subject to above” appearing in clause (b) makes it clear that such observations/comments/ discrepancies/ inconsistencies which are of qualificatory nature relate to necessary information and explanations for the purposes of the audit or the keeping of proper books of accounts or the true and fair view of the financial statements, respectively to be reported on in paragraphs (A), (B) and (C) under clause (b) of paragraph 3. While reporting on clause (a) of paragraph 3 of Form No. 3CB the tax auditor should report only such of those observations/comments/ discrepancies/ inconsistencies which are of qualificatory nature which affect his reporting about obtaining all the information and explanations which were necessary for the purposes of the audit, about the keeping of proper books of account by the head office and branches of the assessee and about the true and fair view of the financial statements. Further, only such observations/comments/ discrepancies/inconsistencies which are of a qualificatory nature should be mentioned under clause (a). Any other observations/comments/ discrepancies/inconsistencies, which do not affect the reporting on the matters specified above may form part of the notes to accounts forming part of the accounts. In case the tax auditor has no observations/comments/ discrepancies/inconsistencies to report which are of qualificatory nature, “NIL” should be reported in this part of paragraph 3. The tax auditor may then give his report as required by sub-paragraphs (A), (B), and (C) of paragraph 3 and paragraph 4.

III.216 Auditing Pronouncements

15.6 Paragraph 4 of Form No.3CB provides that the prescribed particulars are furnished in Form No.3CD annexed to the report. Paragraph 5 of Form No.3CB requires the auditor to report whether in his opinion and to the best of his information and according to the explanations given to him, the particulars given in Form No.3CD are true and correct subject to observations/qualifications, if any. The auditor may have a difference of opinion with regard to the particulars furnished by the assessee and he has to bring these differences under various clauses in Form No.3CD. The auditor should make a specific reference to those clauses in Form No.3CD in which he has expressed his reservations, difference of opinion, disclaimer etc. in this paragraph.

15.7 If a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, has branches and separate accounts are maintained at the branches, the assessee can request the tax auditor appointed under section 44AB to audit the head office and branch accounts. In the alternative, the assessee can appoint separate tax auditors for branches. The branch tax auditor in such a case will have to give an audit report in Form No. 3CB to the management or the tax auditor appointed for the audit of head office accounts. The tax auditor appointed for the audit of head office can rely on the report of branch tax auditors subject to such checks and verifications as he may choose to make and shall submit his consolidated report on the head office and branch accounts. He should make suitable reference to the audit conducted by separate branch tax auditors in the same manner as stated in para 14.6 above.

15.8 If the tax auditor is called upon to give his report only in respect of one or more businesses carried on by the assessee and the books of accounts of the other businesses are not produced as the same are not required to be audited under the Act, the tax auditor should mention the fact that audit has not been conducted of those businesses whose books of account had not been produced. However, if the financial statements include, *inter alia*, the results of such business for which books of account have not been produced, the auditor should qualify his report in Form No. 3CB.

16. Form No. 3CD

16.1 The statement of particulars given in Form No. 3CD as annexure to the audit report contains forty one clauses. The tax auditor has to report whether the particulars are true and correct. This Form is a statement of particulars required to be furnished under section 44AB. The same is to be annexed to the reports in Forms No. 3CA and 3CB in respect of a person who carries on business or profession and whose accounts have been audited under any other law and in respect of person who carries on business or profession but who is not required by or under any other law to get his accounts audited respectively.

16.2 As stated earlier, the tax auditor should obtain from the assessee, the statement of particulars in Form No. 3CD duly authenticated by him. It would be advisable for the assessee to take into consideration the following general principles while preparing the statement of particulars:

- (a) He can rely upon the judicial pronouncements while taking any particular view about inclusion or exclusion of any items in the particulars to be furnished under any of the clauses specified in Form No.3CD.
- (b) If there is a conflict of judicial opinion on any particular issue, he may refer to the view which has been followed while giving the particulars under any specified clause.
- (c) The AS, Guidance Notes, SA issued by the Institute from time to time should be followed.

16.3 While furnishing the particulars in Form No.3CD it would be advisable for the tax auditor to consider the following:

- (a) If a particular item of income/expenditure is covered in more than one of the specified clauses in the statement of particulars, care should be taken to make a suitable cross reference to such items at the appropriate places.
- (b) If there is any difference in the opinion of the tax auditor and that of the assessee in respect of any information furnished in Form No. 3CD, the tax auditor should state both the view points and also the relevant information in order to enable the tax authority to take a decision in the matter.
- (c) If any particular clause in Form No.3CD is not applicable, he should state that the same is not applicable.
- (d) In computing the allowance or disallowance, he should keep in view the law applicable in the relevant year, even though the form of audit report may not have been amended to bring it in conformity with the amended law.
- (e) In case the prescribed particulars are given in part or piecemeal to the tax auditor or relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the auditor should not withhold the entire audit report. In such a case, he can qualify his report on matters in respect of which information is not furnished to him. In the absence of relevant information, the tax auditor would have no option but to state in his report that the relevant information has not been furnished by the assessee.
- (f) The information in Form No.3CD should be based on the books of accounts, records, documents, information and explanations made available to the tax auditor for his examination.
- (g) In case the auditor relies on a judicial pronouncement, he may mention the fact as his observations in clause (3) of Form No.3CA or clause (5) provided in Form No.3CB, as the case may be

17. Particulars to be furnished in Form No.3CD.

PART – A

1. Name of the assessee : _____
2. Address : _____
3. Permanent Account Number : _____
4. Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty, etc. If yes, please furnish the registration number or any other identification number allotted for the same : _____
5. Status : _____
6. Previous year : from _____ to _____
7. Assessment year : _____
8. Indicate the relevant clause of section 44AB under which the audit has been Conducted : _____

[Clauses 1 to 8]

The requirements of clauses 1 to 8 of Part-A are discussed as follows:

17.1 Under clause (1) the name of the assessee whose accounts are being audited under section 44AB should be given. However, if the tax audit is in respect of a branch, name of such branch should be mentioned along with the name of the assessee.

17.2 The address to be mentioned under clause (2) should be the same as has been communicated by the assessee to the Income-tax Department for assessment purposes as on the date of signing of the audit report. If the tax audit is in respect of a branch or a unit, the address of the branch or the unit should be given. In the case of a company, the address of the registered office should also be stated. In the case of a new assessee, the address should be that of the principal place of business.

17.3 Under clause (3) the permanent account number (PAN) allotted to the assessee should be indicated. It may be noted that in the e-filing format PAN is a mandatory field.

17.4 Under clause (4), the auditor is required to mention the registration number or any other identification number, if any, allotted, in case the the assessee is liable to pay indirect taxes like excise duty, service tax, sales tax, customs duty, etc.

17.5 Part A of Form No. 3CD generally requires the auditor to give the factual details of the

assessee. Thus, the auditor is primarily required to furnish the details of registration numbers as provided to him by the assessee. The reporting is however, to be done in the manner or format specified by the e-filing utility in this context.

17.6 The term "Indirect taxes" is neither defined in the Income-tax Act, 1961 nor under any other law. The levy of different types of indirect taxes on various transactions may differ from State to State. Thus, it is recommended that the auditor should obtain from the assessee the list of indirect taxes applicable to him. Once the auditor obtains this management representation, he is required to obtain a copy of the registration certificate clearly mentioning the registration number under that relevant law. For example, Service tax registration number, Excise registration number, VAT registration number/ Central Sales tax Registration number etc. The assessee may have multiple registrations for various manufacturing units, service units, godowns etc under the same law. In such circumstances also, a copy of all registration certificates is to be obtained from the assessee for appropriate disclosure under this clause. Where the indirect tax law does not require any registration, appropriate identification number may be reported in this clause. For example, in Customs Act, 1962, since there is no registration number, a copy of Export Import Code (IEC) may be obtained and information be accordingly furnished.

17.7 The information may be obtained and maintained in the following format:-

Sr. No	Relevant Indirect tax Law which requires registration	Place of Business/ profession/service unit for which registration is in place/ or has been applied for:-	Registration/ Identification number
1	2	3	4

17.8 The auditor has to keep in mind the provisions of Standard on Auditing 580 "Written Representation". In case the auditor prima facie is of the opinion that any indirect taxes laws is applicable on the business or profession of the assessee but the assessee is not registered under the said law, he should report the same appropriately.

17.9 Under clause (5) the status of the assessee is to be mentioned. Obviously this refers to the different classes of assessee included in the definition of "person" in section 2 (31) of the Act, namely, individual, Hindu undivided family, company, firm, an association of persons or a body of individuals whether incorporated or not, a local authority or artificial juridical person.

17.10 Under clause (6) the period of the previous year has to be stated. Since the previous year under the Act now uniformly begins on 1st April and ends on 31st March, the relevant previous year should be mentioned. In case of amalgamations, demergers, reconstitution, new business, closure of existing business etc the date of beginning/ ending of the previous year may be different, the auditor may accordingly, mention the relevant date of beginning and ending of the previous year in this clause. Hence, the tax auditor has to apply his professional judgement depending on the facts and circumstances of the same.

III.220 Auditing Pronouncements

17.11 Under clause (7) the assessment year relevant to the previous year for which the accounts are being audited should be mentioned.

17.12 Under clause (8) the auditor is required to mention the relevant clause of section 44AB under which the audit has been conducted. In case the assessee is carrying on business and his total sales, turnover or gross receipts as the case may be, exceeds one crore in the relevant previous year, the auditor is required to mention clause (a) under this head. If the assessee is carrying on profession and his gross receipts exceed twenty five lakh rupees in the relevant previous year, the auditor is required to mention clause (b) under this head. Likewise, if the audit under section 44AB is being conducted by virtue of provisions of section 44AE, 44BB and 44BBB, the auditor is required to mention clause (c). For audit being conducted by virtue of provisions of section 44AD, clause (d) is to be mentioned under this head.

18. (a) **If firm or Association of Persons, indicate names of partners/members and their profit sharing ratios.**
- (b) **If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change**

[Clause 9(a) and (b)]

18.1 Where the assessee is a firm or association of persons (AOP) or body of individuals, the names of partners of the firm or members of the association of persons or body of individuals and their profit sharing ratios (%) have to be stated. In case where the partner of a firm or the member of AOP/ BOI acts in a representative capacity, the name of the beneficial partner/member should be stated. Thus, the details of partners or members during the entire previous year will have to be furnished. The term "profit sharing ratios" would include loss-sharing ratio also since loss is nothing but negative profits. This would not cover any specific ratio or understanding in relation to payment of remuneration or interest to partners or members. In this connection, reference may be made to Circular No.739 dated 25.3.1996 issued by the Board reproduced in **Appendix XI (Page no. 269)**.

18.2 If there is any change in the partners of the firm or members of the association of persons/ body of individuals or their profit or loss sharing ratio since the last date of the preceding year, the particulars of such change must be stated. All the changes occurring during the entire previous year must be stated.

18.3 The particulars in this clause should be verified from the instrument or agreement or any other document evidencing partnership or association of persons including any supplementary documents or other documents effecting such changes. For this purpose, the tax auditor may also verify:

- (i) in case of registered firms (including Indian LLPs), whether the relevant documents have been filed with the concerned authorities,

- (ii) whether notice of changes, if required, has been given to the registrar of firms, and
- (iii) any minutes or any other understanding recording any changes in the partners/members or their profit sharing ratios.

18.4 The tax auditor should obtain certified copies of the deeds, documents, understanding, notice of changes etc. including certified copies of the acknowledgment, if any, evidencing filing of documents with the concerned authorities, if registered.

18.5 In certain cases of association of persons or body of individuals, it may be possible that the shares of the members are not precisely ascertainable during the previous year resulting in a situation whereby the shares of the members are indeterminate or unknown. In such circumstances, the relevant fact should be stated.

18.6 As per section 2(23) of the Income-tax Act, 1961 the term "Firm" shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include a Limited Liability partnership firm as defined in Limited Liability Partnership Act, 2008.

19. (a) **Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession)**
- (b) **If there is any change in the nature of business or profession, the particulars of such change.**

[Clause 10 (a) and (b)]

19.1 In regard to the nature of business, the principal line of each business is to be determined and stated in this clause, i.e. the sector in which the business or profession falls such as manufacturing, trading, commission agent, builder, contractor, professionals, service sector, financial service sector or entertainment industry. In case of a person belongs to service sector the nature of each type of service should be broadly stated. Thereafter, the auditor is required to mention the sub-sector pertaining to the sector selected.

19.2 . Information has to be furnished in respect of each business. The code to be mentioned against the nature of business pertains to the main area of business activity.

19.3 Any material change in the nature of business should be precisely set out. The change will include change from manufacturer to trader as well as change in the principal line of business. For example, an assessee switching over from wholesale business to retail business or an assessee switching over from manufacturing his own commodities to manufacturing goods on job basis for others. Likewise, any addition to or permanent discontinuance of, a particular line of business may also amount to change requiring reporting. However, temporary suspension of the business may not amount to change and therefore need not be reported.

19.4 A review of business report or the minutes of meetings would enable the tax auditor to

III.222 Auditing Pronouncements

note the changes, if any. Based thereon, he may make necessary enquiries and seek information and determine whether any change has occurred or not. If need be, the tax auditor should get a declaration from the assessee regarding change in the nature of business, if any.

19.5 In the case of business reorganization/ reconstruction if there is a similar line of activity, no reference needs to be made. However, if a new line of activity emerges because of business reorganization/ reconstruction, the same may be stated. In the case of restructuring, if any line of activity is being hived off, the same may also be reported.

19.6 The auditor should keep in mind the above guidance while furnishing information under this clause in the format provided for in the e-filing utility

20. (a) Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.

(b) List of books of account maintained and the address at which the books of account are kept .

(In case books of account are maintained in a computer system, mention the books of account generated by such computer system. If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.)

(c) List of books of account and nature of relevant documents examined.

[Clause 11 (a) to (c)]

20.1 The list of books of accounts prescribed, maintained and examined has to be stated under this clause. There may be difference between the three lists. For example, books of accounts may have been prescribed but all the prescribed books might not have been maintained or the entire books of accounts maintained might not have been produced for examination. The tax auditor should exercise his professional judgment in order to arrive at the conclusion whether such a situation warrants any disclosure or qualifications while forming his opinion on the matters covered by reporting requirements in Form No.3CB.

20.2 The CBDT under Rule 6F has prescribed the books of account and other documents to be kept and maintained by a person carrying on certain professions specified in sub-section (1) of section 44AA. As such, every person carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or authorised representative or film artist and whose total gross receipts exceed one lakh fifty thousand rupees in all the three years immediately preceding the previous year, or where the profession has been newly set up in the previous year, his total gross receipts in the profession for that year are likely to exceed the said amount, is required to maintain the following books of account:

1. Cash book.
2. Journal, if the accounts are maintained according to the mercantile system of

accounting.

3. Ledger.

Apart from the aforesaid books of account, a person carrying on medical profession is required to keep the following:

- (a) daily case register in Form No.3C showing data, patient's name, nature of professional services rendered, fees received and date of receipt; and
- (b) an inventory under broad heads, as on the first and the last days of the previous year, of the stock of drugs, medicines and other consumable accessories used for the purpose of his profession.

20.3 In the case of a person for whom the books of account have been prescribed under rule 6F, the list of books so prescribed have to be stated under clause 11(a). It may be noted that the daily case register and the inventory under broad heads do not constitute books of account and hence the same need not be mentioned under clause 11(a). Sometimes an assessee may carry on multiple activities. Books of account might have been prescribed for one of the activities. In that case, mention may be made of the activity for which books have been prescribed.

20.4 The tax auditor should obtain from the assessee a complete list of books of account and other documents maintained by him (both financial and non-financial records) and make appropriate marks of identification to ensure the identification of the books and records produced before him for audit. The list of books of account maintained by the assessee should be given under clause 11(b).

20.5 Section 44AA(2) provides that persons carrying on business or profession, other than those specified in sub-section (1), shall keep and maintain such books of account and other documents as may enable the Assessing Officer to compute his total income in accordance with the provisions of the Income-tax Act, if his income from business or profession exceeds the monetary limits prescribed under section 44AA(2) or his total sales, turnover or gross receipts in business or profession exceed the monetary limits prescribed under section 44AA(2) in any one of the three years immediately preceding the previous year. The tax auditor will, therefore, have to verify that the assessee has maintained such books of accounts and documents as may enable the Assessing Officer to compute the total income of the assessee in accordance with the provisions of the Act. It may be noted that though the Central Board of Direct Taxes has been empowered under sub-section (3) of section 44AA to prescribe books of account to be maintained under sub-section (2), so far no books of accounts have been prescribed.

20.6 For a person whose accounts of the business or profession have been audited under any other law, the requirement for maintenance of books of account is contained in the relevant statutes. In the case of other assessees, normal books of account to be maintained will be cash book/bank book, sales/purchase journal or register and ledger. Assesseees

III.224 Auditing Pronouncements

engaged in trading/manufacturing activities should also maintain quantitative details of principal items of stores, raw materials and finished goods. While giving his report in Form No. 3CB about maintenance of proper books of account, the tax auditor should ensure that they are maintained in accordance with the above requirements. In case where stock records are not properly maintained by the assessee due to the nature, level, volume and variety of items/ transactions, the tax auditor will have to consider the concept of materiality and practicality while giving particulars in Form No. 3CD.

20.7 (a) As per section 2(12A) of the Income-tax Act, 1961, "books or books of account" includes ledgers, day-books, cash books, account-books and other books, whether kept in the written form or as print-outs of data stored in a floppy, disc, tape or any other form of electro-magnetic data storage device. As to the requirement regarding the mentioning of the books of accounts generated by the computer system, the tax auditor should obtain a list of books of account which are generated by the computer system. The list given by the assessee can be verified from the printout of such books obtained from the assessee. Only such books of account and other records which properly come within the scope of the expression "proper books of account" should be mentioned.

(b) It may be noted that section 4 of the Information Technology Act, 2000 states that "Where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied if such information or matter is-

- (i) rendered or made available in an electronic form; and
- (ii) accessible so as to be usable for a subsequent reference."

20.8 From AY 2014-15, the address at which the books so maintained are kept is also required to be mentioned under clause (b). In case the books of accounts are kept at more than one location then the auditor is required to mention the details of address of each such location along with the detail of books of account maintained thereof. The auditor is advised to obtain from the assessee a list in the following format and accordingly report the same in clause 11(b). In case of a company assessee auditor should also verify as to whether any forms are filed under the Companies Act for maintenance of books of accounts at a place other than the registered office:

Sr No.	Principal place of maintenance of books of accounts	Details of books maintained
1	2	3

20.9 In case, where books of accounts are maintained and generated through computer system, the auditor should obtain from the assessee the details of address of the place where the server is located or the principal place of business/Head office or registered office by whatever name called and mention the same accordingly in clause 11(b).

20.10 Books of account examined would constitute the books of original entry and the other books of account. In addition to the list of books of accounts examined, the auditor is required to mention the nature of relevant documents examined also. Since the assessee is required to maintain evidence such as bills, vouchers, receipts, debit note, credit note, inventory register, agreements, orders etc., the auditor generally examines these documents while conducting audit. The underlying documents would differ from assessee to assessee depending on the nature of activity carried on by the assessee. Reference to such supporting evidence/ relevant documents is also required to be made under this clause. Attention is drawn to Para 14.3 and 14.4 for guidance with regard to the term “relevant documents”.

21. Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB Chapter XII-G, First Schedule or any other relevant section).

[Clause 12]

21.1 Where the profits and gains of the business are assessable to tax under presumptive basis under any of the sections mentioned below, the amount of such profits and gains credited/debited to the profit and loss account should be indicated under this clause:

S. No.	Section	Business covered
1	44AD	Eligible business
2	44AE	Transport business
3	44B	Shipping business of a non-resident
4	44BB	Providing service or facilities in connection with, or supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils
5	44BBA	Operation of aircraft by non-resident
6	44BBB	Civil construction etc. in certain turnkey power project by non-residents
7	Chapter XII-G	Special provisions relating to Shipping Companies (Section 115V to 115VT)
8	First Schedule	Insurance Business
9	Any other relevant section	This refers to the sections not listed above under which income may be assessable on presumptive basis like section 44D and section 115A(1)(b) and will include any other section that may be enacted in future for presumptive taxation

If the profit and loss account does not include profit assessable on presumptive basis, then, there is no requirement to furnish the particulars under this clause.

21.2 The amount to be mentioned under this clause means the amount included in the profit and loss account. The tax auditor is not required to indicate as to whether such amount corresponds to the amount assessable under the relevant section relating to presumptive

III.226 Auditing Pronouncements

taxation. As such, the reporting requirement gets satisfied if the amount as per profit and loss account is reported.

21.3 The tax auditor may come across three different situations as follows:

- (a) Where the assessee, maintaining regular books of account has more than one business which include business of the nature assessable on presumptive basis under any of the said sections and the profit and loss account prepared from such books of account, *inter alia*, includes the income of the business assessable under the scheme of presumptive taxation.
- (b) Where the assessee has more than one business including some business(es) falling under any of the aforesaid sections, but maintains separate sets of accounts for each such business and opts for getting the accounts of all such businesses audited under section 44AB.
- (c) Where the assessee, having regular books of account for his main business, has some additional business of the nature described in any of the aforesaid sections and no books of account whatsoever is maintained for such additional business but the net income is credited to the main profit & loss account of the assessee.

21.4 Under each of the aforesaid three situations, the tax auditor may proceed as follows:

- (a) This situation may give rise to the problem of apportionment of common expenditure in order to arrive at the correct amount of profit credited to profit and loss account and assessable on a presumptive basis. In such a situation, the endeavour of the tax auditor should be to arrive at a fair and reasonable estimate of such expenditure on the basis of evidence in possession of the assessee or by asking the assessee to prepare such estimate which should be checked by him. It is also necessary to mention the basis of apportionment of common expenditure. However, if the tax auditor is not satisfied with the reasonableness of such apportionment, he should indicate such fact under this clause by a suitable note.
- (b) In this case, since a separate set of accounts are maintained for respective businesses, it poses no problem for the tax auditor in ascertaining the amount of profit to be disclosed.
- (c) Here, the tax auditor is unable to satisfy himself about the correctness of the net income from the presumptive business credited to the profit and loss account. He should, therefore, state the amount of income as appearing in the profit and loss account, with a suitable note expressing his inability to verify the said figure. In the absence of books of account, the tax auditor would be unable to form an opinion about the true and fair view of the profit and loss account or balance sheet of the assessee and therefore, it would become necessary for him to qualify his report in Form No. 3CB.

21.5 In the case of an assessee opting against presumptive taxation, the provisions of section 44AB (c) requires such an assessee to get his accounts audited irrespective of the fact that his turnover has not exceeded the prescribed limit (presently Rs. 1 crore w.e.f A.Y.

2013-14) . There may be another circumstance where an assessee has mixed nature of business amenable to taxation on presumptive basis and under normal provisions of law – turnover of which does not exceed the prescribed limit (presently Rs. 1 crore w.e.f. A.Y. 2013-14). In such a case, the tax auditor auditing the books of account etc. relating to business covered by the provisions relating to presumptive taxation should sufficiently indicate in his report that his audit report in Form No. 3CB and particulars in Form No.3 CD only relate to the business covered by the provisions relating to presumptive taxation and his audit report does not relate to business assessable under the normal provisions of the Act.

21.6 Even where the assessee opts for presumptive taxation, the tax auditor should impress upon the assessee that it would be advisable to maintain some basic records to support the turnover/gross receipts declared for presumptive taxation.

21.7 Where the profit and loss account includes any profits and gains assessable by virtue of provisions of section 44AE, the auditor should obtain and verify the following information from the assessee:

Sr No.	Nature of vehicle	No. of Vehicles	Month of acquisition in case of vehicle purchased during the relevant previous year	Presumptive income per month	Number of months Owned during the previous year (Part of the month to be rounded off)	Presumptive income for the previous year
1	2	3	4	5	6	7

21.8 In respect of provisions relating to Chapter XII-G, the auditor should obtain and verify the following information from the assessee being a qualifying shipping company:

Sr No.	Name of the Ship	Net tonnage capacity as per DGS certificate	Net tonnage capacity rounded off to nearest 100	Tonnage income per day	No of days operated during the previous year as per DGS Certificate	Tonnage income per year
1	2	3	4	5	6	7

21.9 The auditor should keep in mind the above guidance while furnishing information under this clause in the format provided in the e-filing utility.

22. (a) **Method of accounting employed in the previous year.**
 (b) **Whether there had been any change in the method of accounting employed**

vis-a-vis the method employed in the immediately preceding previous year.

- (c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)

- (d) Details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.

[Clause 13 (a) to (d)]

22.1 The Finance Act, 1995 amended section 145 with effect from assessment year 1997-98 to provide that the income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” must be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. It has also been provided that the Central Government may notify in the Official Gazette from time to time the accounting standards to be followed by any class of assessee or in respect of any class of income. The hybrid system of accounting viz. mixture of cash and mercantile hitherto allowed to be followed by the assessee was not permitted from assessment year 1997-98 & onwards. However, the assessee may adopt cash system of accounting for one business and mercantile system of accounting for other business. Once the choice of method of accounting is decided, the assessee must follow consistently the method of accounting employed. If he employs different methods for different businesses regularly and consistently, the profits would have to be computed in accordance with the respective methods, provided the result is a proper determination of profits. As regards the accrual system of accounting, the Institute has published a “Guidance Note on Accrual Basis of Accounting” which may be referred to.

22.2 It may be noted that in view of amendment made by the Companies (Amendment) Act, 1988 in section 209 of the Companies Act, 1956 every company is required to keep books of account on accrual basis. In other words, a company governed by the Companies Act, 1956 cannot follow cash system of accounting unless exempted under the Companies Act, 1956/2013. The provisions of section 209 (3) of the Companies Act, 1956 are, however, not applicable to entities other than companies. Section 209 has been replaced with the section 128/129 in the Companies Act, 2013 w.e.f. 1.4.2014.

22.3 Under sub-clause (b), whether there has been any change in the method of accounting employed vis-à-vis the method employed in the immediately preceding previous year is to be stated. As already noted, an assessee can follow either cash or mercantile system of accounting.

22.4 If there is any change, the effect thereof i.e. increase or decrease in profits has to be stated under this clause. So far as the question of effect of such change on the profit or loss is

concerned, the concept of materiality is the basic governing factor. If it is not possible to quantify the effect of the change in the method of accounting, appropriate disclosure should be made under this clause.

22.5 An assessee can follow a number of accounting policies for the purpose of maintaining his books of account. As per AS-1 all significant accounting policies adopted in the preparation and presentation of financial statements shall be disclosed. The disclosure of the significant accounting policies shall form part of the financial statements and the significant accounting policies shall normally be disclosed in one place. Any change in an accounting policy which has a material effect in the previous year or in the years subsequent to the previous year shall be disclosed. The impact of, and the adjustments resulting from such change, if material, shall be shown in the financial statement of the period in which such change is made to reflect the effect of such change.

22.6 As per paragraph 9 under AS(IT) relating to disclosure of prior period and extraordinary items and changes in accounting policies, a change in an accounting policy can be made only if:

- (a) adoption of different policy is required by the statute; or
- (b) the change would result in a more appropriate presentation of the financial statements.

22.7 A change in an accounting policy will not amount to a change in the method of accounting and hence such change in the accounting policy need not be mentioned under sub-clause (b). This is due to the fact that as per the requirements of AS-1 and AS (IT)-1 such changes and the impact of such changes will be disclosed in the financial statements. It may be noted that a change in the method of valuation of stock will amount only to a change in an accounting policy and hence such a change need not be mentioned under sub-clause 13(b) but should be mentioned in the financial statements.

22.8 The tax auditor should apply reasonable checks to the earlier year's accounts to ascertain whether there is any change in the method of accounting as compared to that of the year under audit, after obtaining a written confirmation from the assessee as to the method of accounting followed.

22.9 It must also be ascertained as to whether the AS (IT) as may be applicable to the assessee or to the class of income, have been followed. Presently, only two AS (IT) have been prescribed. – AS (IT)-I relating to disclosure of accounting policies and AS (IT)-II relating to disclosure of prior period and extraordinary items and changes in profit and loss account. The tax auditor has to report the details of the deviations in the method of accounting in the previous year from the AS(IT) and the effect thereon on the profit or loss. The tax auditor, while reporting on prior period and extraordinary items should report only such items which fall within the meaning of prior period items and extraordinary items in the relevant AS (IT). Attention is invited to AS (IT)-II, paragraph 10, according to which any change in an accounting policy which has a material effect is required to be disclosed. As stated above, a

III.230 Auditing Pronouncements

change in the method of valuation of closing stock would amount to a change in an accounting policy and has to be stated in the financial statements. The tax auditor should ensure that in case the same is not stated in the financial statements, the fact should suitably be stated under clause 13(d). He may rely on the various pronouncements and clarifications made by the ICAI.

22.10 The Finance (No. 2) Act, 2014 has amended section 145 w.e.f AY 2015-16 to the effect that the words 'accounting standards' be replaced with the words 'income computation and disclosure standards'. As per the memorandum explaining the Finance (No. 2) Bill 2014, such an amendment has been made in order to clarify that the standards notified under section 145(2) are only meant for computation of income and disclosure of information and the assessee need not maintain books of account on the basis of AS notified under the Income-tax Act, 1961. The Accounting Standards issued by ICAI/ Companies Accounting Standard Rule, 2006 would still be required to be followed by the assessee, for preparation of financial statements.

- 23. (a) Method of valuation of closing stock employed in the previous year.**
(b) Details of deviation, if any, from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish:

Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)

[Clause 14 (a) and (b)]

23.1 The method of valuation of closing stock is to be stated under this clause. AS-2 "Valuation of Inventories" issued by ICAI requires disclosure of significant accounting policies. Accordingly, a reference may be invited to the same or the method of valuation may be again described in Form No.3CD.

23.2 The method of valuation followed by the assessee having regard to the articles or goods dealt in or manufactured by the assessee, should be clearly indicated. Some examples are given below:

- (i) raw material at cost or net realisable value whichever is lower,
- (ii) finished goods at cost or net realizable value whichever is lower.

23.3 In sub-clause (a) of clause 14 of Form No.3CD, the reference is made to "closing stock". The expression "stock-in-trade" means finished goods and raw materials. Since sub-clause (b) refers to section 145A where the term "inventories" is used, the term "closing stock" will include all items of inventories. AS-2 defines the term "inventories" to include finished goods, raw materials, work-in-progress, materials, maintenance supplies, consumables and loose tools. Therefore, method of valuation of items of inventories will have to be given under sub-clause (a).

23.4 The tax auditor should study the procedure followed by the assessee in taking the

inventory of closing stock at the end of the year and the valuation thereof. He should obtain the inventory of closing stock, indicating the basis of valuation thereof, for reporting on the method of valuation of closing stock under this clause.

23.5 The method of stock valuation must be consistently followed from year to year and the method followed must be brought out clearly. The tax auditor should examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is necessary to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains. The Supreme Court in case of *CIT v. British Paints Ltd.* [1991] 188 ITR 44 (SC) has held that the method of valuation of stock at actual cost of raw materials and not taking into account overhead charges was not the correct method of valuation even though the said method has been consistently followed. As per AS-2 - Valuation of inventories (Revised) (from accounting year starting from 1.4.1999), historical cost of manufactured inventories can be arrived at on the basis of absorption costing alone and the allocation of fixed costs of inventories should be based on the normal level of production only. It is further provided that overheads should be included as part of the inventory cost only to the extent that they clearly relate to putting the inventories in their present location and condition.

23.6 It is not necessary to indicate any change in the method of valuation of closing stock under this clause. However, as stated earlier in paragraph 22.6, any such change in the method of valuation of closing stock would amount to change in an accounting policy and needs to be disclosed in the financial statements as required by AS-1 and AS(IT).

23.7 The details of deviation, if any, from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss have to be stated under clause 14(b).

23.8 Section 145A was enacted by the Finance (No.2) Act, 1998 and came into force from A.Y. 1999-2000. This section provides that the valuation of purchase and sale of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of the method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustments provided in this section can be made while computing the income for the purpose of preparing the return of income. These adjustments are as follows:

- (a) Any tax, duty, cess or fee actually paid or incurred on inputs should be added to the cost of inputs (raw materials, stores etc.) if not already added in the books of account.
- (b) Any tax, duty, cess or fee actually paid or incurred on sale of goods should be added to the sales, if not already added in the books of account.
- (c) Any tax, duty, cess or fee actually paid or incurred on the inventory (finished goods, work-in-progress, raw materials etc.) should be added to the inventories, if not already added while valuing the inventory in the accounts.

23.9 The statutory adjustments required under section 145A can be explained by the following example.

III.232 Auditing Pronouncements

Particulars	Qty	Rate excluding excise duty	Rate of excise duty
Opening stock	10	10	2
Raw material purchased	90	10	2
Other manufacturing cost	80	10	-
Finished goods manufactured	80	-	-
Sales of finished goods	60	25	3
Closing stock of raw material	20	10	2
Closing stock of finished goods	20	20	3

The input output ratio of raw material to finished goods is 1: 1

23.10 It may be stated that the CENVAT is a procedure whereby manufacturer can utilise credit for input duty against duty payable on final products. Duty credit taken on input is of the nature of set off available against the excise duty payable on the final products. For the accounting periods ending on or before 31st March, 1999, the following two alternative methods of treatment of CENVAT credit in the accounts are permissible.

- I. Duty paid on inputs may be debited to a separate account, e.g. CENVAT credit receivable account. As and when the CENVAT credit is actually utilised against payment of excise duty on final products appropriate accounting entries will be required to adjust the excise duty paid out of "CENVAT credit receivable account" to the account maintained for payment/provision for excise duty on final product. In this case, the purchase cost of the inputs would be net of input duty. Therefore, the inputs consumed and the inventory of inputs would be valued on the basis of purchase cost net of input duty. This method is hereinafter referred to as "exclusive method".
- II. In the second alternative, the cost of inputs may be recorded at the total amount paid to the supplier inclusive of input duty. To the extent the CENVAT credit is utilised for payment of excise duty on final products, the amount could be credited to a separate account, i.e. CENVAT credit availed account. Out of the CENVAT credit availed account, the amount of CENVAT credit availed in respect of consumption of inputs would be reduced from the total cost of inputs consumed. This method is hereinafter referred to as "inclusive method".

The effect of section 145A is to reflect the figures on "inclusive method".

Following two illustrations explain the above propositions.

The profit & loss account on "exclusive method" would be as under:

Item	Particulars	Unit	Rate	Amount	Amount	Item	Particulars	Unit	Rate	Amount
(a)	Opening Stock	10	10	100		(h)	By sales	60	25	1,500
(b)	Purchase of raw material	90	10	900		(i)	By closing stock of finished goods	20	20	400
	Total	100	10	1000						
(c)	Less closing stock of raw Material	20	10	200						
(d)	Raw material consumed	80	10		800					
(e)	To manufacturing Cost	80	10		800					
(f)	To excise duty on finished goods sold				0					
(g)	To gross Profit				300					
	TOTAL				1900		TOTAL			1900

The profit & loss account on “inclusive method” which is also in accordance with the provisions of section 145A would be as under:

Item	Particulars	Unit	Rate	Amount	Amount	Item	Particulars	Unit	Rate	Amount
(j)	Opening stock	10	12	120		(s)	By sales	60	28	1680
(k)	Purchase of raw material	90	12	1080		(t)	By closing stock of finished goods	20	23	460
	Total	100	12	1200						
(l)	Less closing stock	20	12	240						
(m)	Less CENVAT credit	80	2	160						
(n)	Raw material Consumed	80	10		800					
(o)	To manufacturing cost	80	10		800					
(p)	To excise duty on finished goods	60	3		180					

III.234 Auditing Pronouncements

(q)	To excise duty on closing stock of finished goods	20	3		60				
(r)	To gross profit				300				
	TOTAL				2140		TOTAL		2140

23.11 It may be pointed out that the "inclusive method" is not permitted by AS-2 which is made mandatory from accounting year beginning on or after 01.04.1999. Further, in the Guidance Note on Accounting for CENVAT the second method (inclusive method) has been withdrawn with effect from accounting year commencing from 1.4.1999. In view of the above, the adjustments under section 145A will have to be made in all cases where 'exclusive method' is followed.

23.12 In this connection, it is worthwhile to note that the Memorandum explaining the provisions of section 145A inserted by the Finance (No.2) Bill, 1998 states as follows:

“Computation of value of inventory.

The issue relating to whether the value of closing stock of the inputs, work-in-progress and finished goods must necessarily include the element for which MODVAT credit is available has been the matter of considerable litigation.*

In order to ensure that the value of opening and closing stock (bold for emphasis) reflect the correct value, it is proposed to insert a new section to clarify that while computing the value of the inventory as per the method of accounting regularly employed by the assessee, the same shall include the amount of any tax, duty, cess or fees paid or liability incurred for the same under any law in force.

The proposed amendment which is clarificatory in nature shall take effect retrospectively from the 1st day of April, 1986 and will accordingly apply in relation to assessment year 1986-87 and subsequent years.

[Clause 45]”

*Now CENVAT.

(Section 145A was initially proposed to be applicable in relation to assessment year 1986-87 and subsequent years. However, later on, when the Finance (No.2) Bill, 1998 was enacted into law the provision was made applicable from 1.4.1999 i.e. assessment year 1999-2000)

23.13 It may be noted that when the adjustments are made in the valuation of inventories, this will affect both the opening as well as closing stock. Whatever adjustment is made in the valuation of closing stock, the same will be reflected in the opening stock also. Question for consideration is whether the opening stock as on 1.4.1998 should be adjusted as required under section 145A. It is now well settled that if any adjustment is required to be made by a statute, effect to the same should be given irrespective of any consequences on the

computation of income for tax purposes. Section 145A starts with the *non obstante* clause "Notwithstanding anything to the contrary contained in section 145". Therefore, to give effect to section 145A, the opening stock as on 1.4.98 will have to be increased by any tax, duty, cess or fee actually paid or incurred with reference to such stock if the same has not been added for the purpose of valuation in the accounts.

23.14 It may be noted that while making the adjustments stated in Para 23.8 and 23.13 above, the tax auditor should ensure that if any deduction is claimed for any tax, duty, cess or fee on the items covered by these two paragraphs by way of debit in the profit and loss account, either in the earlier year or in the year under report, adjustment for the same should be made in such a manner that no double deduction is claimed for the same expenditure. Similarly, adjustment should be made for any item of income to ensure that the same item is not treated as income twice.

23.15 When the exclusive method is followed in the accounts, the adjustments to be made under section 145A can be explained by the following illustrations which are required to be reported under clause 14(b).

Sl. No.	Particulars	(Rupees) Increase in Profit	(Rupees) Decrease in Profit
1.	Increase in cost of opening stock on inclusion of excise duty on which CENVAT credit is available/availed (j - a)		20
2.	Increase in purchase cost of raw material on inclusion of excise duty on which CENVAT credit is available/availed (k - b)		180
3.	Increase in sales of finished goods on inclusion of excise duty (s - h)	180	
4.	Excise duty paid on sale of finished goods as a result of its inclusion in sales (p-f)	-	180
5.	Increase in closing stock of raw material on inclusion of excise duty (l - c)	40	-
6.	Increase in closing stock of finished goods on inclusion of excise duty (t - i)	60	-
7.	Increase in excise duty on closing stock of finished goods as a result of its inclusion in closing stock of finished goods (q)	-	60
8.	Accounting of CENVAT credit availed and utilised on raw materials consumed in payment of excise duty on finished goods accounted on the basis of raw material consumed (m)	160	-
	TOTAL	440	440

It may be noted that the net impact on the profit or loss will be nil.

III.236 Auditing Pronouncements

Note 1: The reference in brackets is to items in the illustration given in paragraphs 23.10 above.

Note 2: The CENVAT credit in the "inclusive method" has been worked out on the basis of quantity of raw material consumed multiplied by excise duty paid on purchase of such raw material (Rs.160) (item m), though the CENVAT credit set off availed and utilized by the assessee against payment of excise duty on finished goods is Rs.180. This is so because the raw material consumed during the year under both the methods is Rs.800. The CENVAT credit in the inclusive method would have to be deducted from purchase of raw material on the basis of consumption of raw material and not on the basis of set off availed in excise law to arrive at correct cost of consumption. In the illustration if CENVAT credit of Rs.180 is accounted, then the raw material consumed would be Rs.780. This figure would not be the correct figure of consumption, since 80 units have been consumed and the net cost of each raw material is Rs.10 (12-2). In other words, the consumption of raw material to be debited during the year should be Rs.800 i.e. 80 units multiplied by 10. So also the figure of excise duty on finished goods sold of Rs.180 is correctly debited because the same represents excise duty on finished goods sold and the same cannot be changed on account of CENVAT credit set off availed.

In the inclusive method the cost of the finished goods have been taken at Rs.20 plus Rs.3 excise duty. The raw material component included in the finished goods has been taken at Rs.10 since CENVAT credit have been accounted at the rate of Rs.2 in arriving at consumption of raw material.

Note 3: Similar treatment should be given for other tax, duty, cess, or fee paid by the assessee i.e. sales tax etc.

Note 4: It may be noted that liability for sales tax arises on sale as against liability for excise duty which arises on manufacture. As such the liability for sales tax need not be adjusted in the closing stock of finished goods before the same are sold.

23.16 It may be noted that after making the above addition to the closing stock under section 145A, it will be possible to claim a separate deduction for excise duty actually paid after the year end but before the due date for filing the return of income on production of evidence as provided under section 43B. Therefore, in the above illustration if the assessee has paid Rs.60 added in the valuation of closing stock of finished goods before the due date for filing the return, deduction for the same can be separately claimed in the computation of income under section 43B, if other conditions of those sections are satisfied.

23.17 The computation of total income would appear as under :

	Rs.	Rs.	Rs.
Profit as per Profit and Loss account on the basis of exclusive method (see paragraph 23.10)			300
<i>Add:</i> Adjustments required under section 145A:			

1)	Excise duty on sales (Rs.3/ per unit for 60 units)	180		
2)	Excise duty on closing stock of raw materials (Rs. 2/- per unit for 20 units)	40		
3)	Excise duty on closing stock of finished goods (Rs.3/ per unit for 20 units)	60		
4)	CENVAT credit utilized on consumption of raw materials (Rs.2/- per unit for 80 units)	160	440	

<i>Less:</i>				
1)	Excise duty on opening stock of raw material (Rs.2/- per unit for 10 units)	20		
2)	Excise duty on purchase of raw materials (Rs.2/- per unit on 90 units)	180		
3)	Excise duty on sales (paid or incurred as per section 145A)	180	380	60
		-----	-----	-----
				360
<i>*Less:</i> Deduction under section 43B on the assumption that the amount is paid on or before due date of filing return of income in respect of excise duty payable on finished goods				60

	Profit			300

23.18 The input State-Level Value Added Tax (VAT) paid on purchases cannot be included in the cost of purchases where the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is in the nature of taxes recoverable from taxing authorities. The Accounting Standard (AS) 2 "Valuation of Inventories" deals with "cost of inventories" and "cost of purchases". As per para 6 and 7 of the said AS-2, the cost of purchases cannot include duties and the taxes which are subsequently recoverable from the taxing authorities. Hence the input tax which is refundable, should not be included in the cost

III.238 Auditing Pronouncements

of purchases.

23.19 The Input State-Level VAT, to the extent it is refundable, will not form part of the cost of the inventory. The inventory of inputs is to be valued at net of the input tax which is refundable. If the inputs are obtained from the dealers who are exempt from the VAT, the actual cost of purchase should be considered as a part of cost of inventory.

23.20 A dealer may purchase certain common inputs which can be used for manufacturing goods which are declared tax free as well as taxable goods. In such case, the dealer should estimate inputs expected to be used for making tax free goods and for making taxable goods. The dealer should recognize VAT credit only in respect of those inputs which are used for making taxable goods and no VAT credit should be recognized in respect of inputs used for making tax free goods. Similar accounting treatment should be given in the case of stock transfer/ consignment sale of goods out of the State where VAT credit is available only to the extent of a certain portion of input tax paid.

23.21 VAT is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise. It does not result in any increase in the equity of the enterprise. Accordingly, it should not be recognized as an income of the enterprise. Similarly, the payment of VAT should not be treated as an expense in the financial statements of the enterprise. Therefore, it should be credited to an appropriate account, say, 'VAT Payable Account'. In case the VAT has not been charged separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to 'VAT Payable Account' at periodic intervals. The amount of VAT payable adjusted against the VAT Credit Receivable (Capital Goods) Account and amounts paid in cash will be debited to this account. The credit balance in VAT Payable Account at the year-end should be shown on the 'Liabilities' side of the balance sheet under the head 'Current Liabilities'. It is important to note that where the assessee is enjoying tax holiday under the relevant state law as a result of which the liability to pay is deferred for a period of more than one year then it should be reflected as a long term liability.

23.22 Section 145A of the Income-tax Act provides that the valuation of purchase and sales of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustment provided for in this section should be made while computing the income for the purpose of preparing the return of income. Therefore, the recommended method for accounting of VAT will not result in non-compliance of section 145A of the Income-tax Act.

23.23 The adjustments envisaged by section 145A will not have any impact on the trading account of the assessee. In other words both under exclusive method of accounting and

inclusive method of accounting, the gross profit in the trading account will remain the same. The same is illustrated for a trading concern and a manufacturing concern as follows:

(I) Trading Concern

Assuming that the assessee has opening stock of Rs.3,30,000/- on which input tax rebate of Rs.30,000/- is available. During the year three items purchased @ Rs.3,00,000/- per item. VAT on purchase @ 10%. There is no opening stock. Two items are sold @ Rs.4,50,000/- per item. VAT on sales @ 10%

The Trading Account on “EXCLUSIVE METHOD”

Particulars	Qty.	Rate	Amount	Particulars	Qty.	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,50,000	9,00,000
Less Input tax rebate			30,000				
			3,00,000				
To Purchases	3	3,00,000	9,00,000	By Closing Stock	2	3,00,000	6,00,000
To Gross Profit			<u>3,00,000</u>				
Total			<u>15,00,000</u>				15,00,000

The Trading Account on “INCLUSIVE METHOD”

Particulars	Qty.	Rate	Amount	Particulars	Qty.	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	2	3,30,000	6,60,000
			<u>13,20,000</u>				
Less: VAT credit availed on cost of goods sold			60,000				
			12,60,000				
VAT paid on sales			90,000				
Gross Profit			3,00,000				
			<u>16,50,000</u>				16,50,000

The statutory adjustments required under section 145A can be explained by the following

III.240 Auditing Pronouncements

example:

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	Increase in Opening Stock on inclusion of VAT		30,000
2.	Increase in Purchases on inclusion of VAT		90,000
3.	Increase in Sales on inclusion of VAT	90,000	
4.	Increase in Closing Stock on inclusion of VAT	60,000	
5.	VAT paid on sales		90,000
6.	VAT credit availed on cost of goods sold	60,000	
		2,10,000	2,10,000

The net impact on Profit & Loss Account is NIL.

The computation of total income would appear as under:-

Profit as per Profit & Loss account on the basis of exclusive method Rs.3,00,000

Add: Adjustments required under section 145A

1.	Increase in Sales on inclusion of VAT	Rs. 90,000
2.	Increase in Closing Stock on inclusion of VAT	Rs. 60,000
	Total	Rs. 4,50,000

Less:

1.	Increase in Opening Stock on inclusion of VAT	Rs. 30,000
2.	VAT Credit Receivables (Input) A/c	Rs. 90,000
3.	VAT Paid on sales 90,000	
	Less: VAT Credit availed on Cost of Goods Sold 60,000	
	Net VAT Paid	<u>Rs.30,000</u>
	Profit	Rs. <u>3,00,000</u>

(II) Manufacturing concern

The following information is considered in the case of a manufacturing concern:-

Opening Stock of Raw Material 50 units	@ Rs.100 per unit
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Purchases of Raw Material 300 units	@ Rs.100 per unit
Sales 250 units	@ Rs.150 per unit
Manufacturing Expenses	Rs.3,000
Closing Stock of Raw Material	50 units
Closing Stock of Finished Goods	50 units
Rate of VAT on purchases and sales	4%

Manufacturing Account on "EXCLUSIVE METHOD"

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	100	5,000		By Sales	250	150	37,500
Purchase of raw materials	300	100	30,000		By closing stock of finished goods	50	110	5,500
Total	350	100	35,000					
Less: Closing Stock of raw material	50	100	5,000					
Raw material Consumed (C) = (A) – (B)	300			30,000				
To manufacturing Expenses	300	10		3,000				
To VAT on finished goods sold				0				
To gross profit				10,000				
Total				43,000	Total			43,000

Manufacturing Account on "INCLUSIVE METHOD"

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	104	5,200		By Sales	250	156	39,000
Purchase of raw materials	300	104	31,200		By closing stock of finished goods	50	114	5,700
Total	350	104	36,400					
Less: Closing Stock of raw material	50	104	5,200					
Less: VAT on Raw	300	4	1,200					

III.242 Auditing Pronouncements

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Material Consumed								
Raw material Consumed (C) = (A) – (B)	300		100	30,000				
To manufacturing expenses	300		100	3,000				
To VAT on finished goods sold	250	6		1,500				
To VAT included in finished goods on account of inclusion of VAT in the raw material value	50	4		200				
To gross profit				10,000				
Total				44,700	Total			44,700

The valuation of finished goods includes the raw material cost and the manufacturing expenses. The raw material costs is taken at Rs.100 per unit in the exclusive method and Rs.104 in the inclusive method. The overhead cost is Rs.10 per unit.

23.24 It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method. Further, the closing stock of raw materials includes the appropriate VAT. But the VAT is not includible in the closing stock of finished goods since the incidence of VAT arises only on sale. However, VAT on raw material included in the finished goods has also been included in the value of closing stock of finished goods.

The statutory adjustments required under section 145A can be explained by the following example:

Sl. No.	Particulars	Increase in Profit (Rupees)	Decrease in Profit (Rupees)
1.	Increase in cost of opening stock of raw material on inclusion of VAT		200
2.	Increase in purchase on account of inclusion of VAT.		1,200
3.	Increase in sales of finished goods on inclusion of VAT.	1,500	
4.	VAT paid on sale of finished goods as a result of its inclusion in sales		1,500
5.	Increase in closing stock of raw material on inclusion of VAT	200	
6.	Accounting of VAT credit availed and utilized on raw material consumed in payment of VAT on finished goods, accounted on the basis of raw	1,200	

Sl. No.	Particulars	Increase in Profit (Rupees)	Decrease in Profit (Rupees)
	material consumed.		
7.	Increase on account of VAT included in finished goods on account of inclusion of VAT in the raw material value	200	
8.	Increase in VAT on closing stock of finished goods on account of inclusion of VAT in the raw material value		200
Total		3,100	3,100

The net impact on the Profit & Loss Account is NIL.

The computation of total income total income would appear as under:-

Profit as per Profit & Loss account on the basis of exclusive method	Rs.10,000
Add: Adjustments required under section 145A	
1. Increase in Sales on inclusion of VAT	Rs. 1,500
2. Increase in Closing Stock of Raw Material on inclusion of VAT	Rs. 200
3. Increase in Stock of finished goods on account of inclusion of VAT in the raw material value	<u>Rs. 200</u>
	Rs.1,900
Total	Rs.11,900
Less:	
1. VAT on Opening Stock of Raw Material	Rs.200
2. VAT included in Purchases	Rs.1200
3. VAT Paid on Sales	Rs.1500
Less: Input Tax Credit on Raw Material Consumed	Rs.1200
Add: VAT included in Closing Stock Of Finished Goods	Rs.200
	Rs.500
Profit	Rs 10,000

24. Give the following particulars of the capital asset converted into stock-in-trade:-

(a) Description of capital asset;

III.244 Auditing Pronouncements

- (b) **Date of acquisition;**
- (c) **Cost of acquisition;**
- (d) **Amount at which the asset is converted into stock-in-trade.**

[Clause 15]

24.1 For furnishing the particulars required by clause 15, the provisions of section 2(47), 45(2), 47(iv), (v) and 47A have to be kept in mind.

24.2 From the A.Y. 1985-86 onwards the conversion by the owner of an asset into or treatment of such asset as stock-in-trade of a business carried on by him is treated as a 'transfer' within the meaning of section 2(47). Under section 45(2) such a conversion or treatment of capital asset into stock-in-trade will be deemed to be a transfer of the previous year in which the asset is so converted or treated as stock-in-trade. However, the capital gains arising from such a transfer will become chargeable in the previous year in which such converted asset is sold or otherwise transferred. In the case of long-term capital asset, indexation of cost of acquisition and cost of improvement, if any, will be with respect to the previous year in which such conversion took place. The fair market value of the asset, as on the date of such conversion or treatment as stock-in trade, shall be deemed to be the full value of the consideration of the asset. The excess of the sale price over the fair market value as on the date of conversion would be treated as business income and taxed under the head 'profits and gains of business or profession'. The capital gains being the difference between the cost of acquisition and the fair market value on the date of the conversion or treatment as stock-in-trade will be chargeable to tax in the year in which the asset is sold.

24.3 Section 47 of the Act enumerates the transactions which will not be regarded as transfer. Under clause (iv) any transfer of a capital asset by a company to its subsidiary company if the parent company or its nominees hold the whole of the share capital of the subsidiary company and the subsidiary company is an Indian company will not be treated as a transfer. Under clause (v) any transfer of a capital asset by a subsidiary company to the holding company if the whole of the share capital of the subsidiary company is held by the holding company and the holding company is an Indian company will not be considered as a transfer.

24.4 The capital gains exempted by virtue of clause (iv) or clause (v) of section 47 may become chargeable under certain circumstances. The provisions of section 47A are relevant here. Accordingly, where at any time before the expiry of a period of 8 years from the date of transfer of a capital asset referred to in clause (iv) or clause (v) of section 47, such capital asset is converted by the transferee company into, or is treated by it as, stock-in-trade of its business or the parent company or its nominees or, as the case may be, the holding company ceases to hold the whole of the share capital of the subsidiary company, the amount of profits or gains arising from the transfer of such capital assets not charged under section 45 by virtue of the provisions contained in clause (iv) or clause (v) of section 47 shall be deemed to be

income chargeable under the head “capital gains” of the previous year in which such transfer took place.

24.5 The particulars to be stated under new clause 15 should be furnished with respect to the previous year in which the asset has been converted into stock-in-trade. The clause does not require details regarding the taxability of capital gains or business income arising from such deemed transfer.

24.6 Under clause (a) description of the capital asset is required to be mentioned for example shares, security, land, building, plant, machinery etc.

24.7 Under Clause (b) the date of acquisition is to be reported. For ascertaining the correct date the tax auditor will have to refer the accounts of the financial year in which such capital asset is acquired. The date assumes importance for the purpose of determining whether the asset is long-term or short-term in nature.

24.8 Under clause (c) the cost of acquisition is required to be reported. Here the cost of acquisition as per the books of account is to be mentioned. In case of depreciable assets, the carrying cost appearing in the books will be the written down value. But the value to be reported will be the original cost of acquisition. Even in case of an asset acquired prior to the 1st day of April, 1981 the value to be reported will be the original cost of acquisition. The assessee may exercise the option of considering the fair market value of the asset as on 1st April, 1981 for assets acquired prior to that date for the purpose of computation of capital gains as provided under section 55(2)(b)(i). Further, in case of block of assets a particular asset loses its identity and therefore to report the original cost of acquisition may not be possible in all cases. In case of corporate entities where the requirements of CARO are applicable the cost may be available from the fixed asset register. However, in case of companies where CARO is not applicable and other partnership concerns, the reporting requirements as to the original cost of acquisition may not be practically possible.

24.9 Under clause (d) the amount recorded in the books of account at which the asset is converted into stock-in-trade should be stated. Such an amount may not be the fair market value as on the date of conversion or treatment as stock-in-trade. If a value other than carrying cost is recorded then the auditor has to examine the basis of arriving at such a value. The valuation of stock-in-trade is to be examined with reference to AS-2 – Valuation of Inventories. Non-compliance with AS-2 is to be suitably qualified in the main audit report.

24.10 It is desirable that necessary accounting entry is passed in the books of account at the time of conversion of the asset into or treatment of the same as stock-in-trade.

24.11 In the case of assessee like a proprietorship concern, prior to the conversion of the asset into stock-in-trade, the details regarding the date of acquisition and cost of acquisition may not be recorded in the books of account. It is also possible that the year in which the capital asset is acquired, the accounts of the assessee may not have been subjected to audit. Also an assessee can acquire a capital asset through various modes such as discussed under

III.246 Auditing Pronouncements

section 49 of the Act. Under such circumstances the auditor may have to verify the cost and the date of acquisition. The following broad principles need to be kept in mind.

24.12 While verifying the cost of acquisition of the fixed asset, the auditor should bear in mind the principles enunciated in Accounting Standard (AS) 10, Accounting for Fixed Assets. As per paragraph 20 of the said Accounting Standard, the cost of a fixed asset comprises of its purchase price and any attributable cost of bringing the asset to its working condition for its intended use. Thus, in case of capital assets purchased by the assessee, it would relatively be easy for the auditor to verify the cost of acquisition, the evidence being provided by the supporting purchase invoices from the supplier, entries appearing in the bank statements in respect of payment to the supplier, entries appearing in the cash book/ bank statement for payment of cartage installment etc. In case of self-constructed capital assets, the cost would comprise those costs that relate directly to the specific capital asset and those that are attributable to the construction activity in general and can be allocated to the specific asset. In case of Capital assets acquired in exchange or in part exchange for another asset, the cost of the asset acquired is either the fair market value or the net book value of the asset given up, whichever is more clearly evident, adjusted for any balancing payment or receipt of cash or other consideration. In case the capital asset is recorded at the net book value of the asset, the fixed asset register would provide the prime evidence of the value. If, however the capital asset so acquired is recorded at the market value the auditor would need to examine the basis for arriving at the fair market value, for example, the valuer's report, market quotes (in case of listed securities). Where the valuer is the tax auditor's internal/ external, the tax auditor should have regard to the principles laid down in SA 620, *Using the Work of An Auditor's Expert*. In any case the auditor would also need to look into how the assessee has decided the value at which the asset is recorded in the books of account is more clearly evident than the other value. In case of a capital asset acquired by way of inheritance, the auditor may find it difficult to verify the cost of acquisition to the original owner. In case there does not exist any documentary evidence as to the cost of acquisition of the asset to the original owner, say the sale/purchase agreement the auditor may need to rely upon the reports of the experts such as valuers. In addition to the above, the auditor should also refer to the guidance contained in the Guidance Note on Audit of Property, Plant and Equipment issued by the Institute.

25. Amounts not credited to the profit and loss account, being,-

- (a) the items falling within the scope of section 28;
- (b) the proforma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax, where such credits, drawbacks or refunds are admitted as due by the authorities concerned;
- (c) escalation claims accepted during the previous year;
- (d) any other item of income;
- (e) capital receipt, if any.

[Clause 16 (a) to (e)]

25.1 Under this clause various amounts falling within the scope of section 28 which are not credited to the profit and loss account are to be stated. The information under sub-clauses (a), (d) and (e) of clause (16) is to be given with reference to the entries in the books of account and records made available to the tax auditor for the purpose of tax audit under section 44AB. Sub-clauses 16 (b), (c) & (d) require information in respect of items which may also be covered under section 28 and as such will also fall in clause 16 (a). However, those items which are reported in clauses 16(b), (c) and (d) need not be reported in clause 16 (a). The tax auditor may obtain a management representation in writing from the assessee in respect of all items falling under this clause.

25.2 Section 28 refers to

- (i) the profits and gains of any business or profession,
- (ii) any compensation received on termination of employment, agency etc.
- (iii) income derived by a trade, professional or similar association from specific services performed for its members,
- (iiia) profits on sale of a licence granted under the Imports Control Order, 1955,
- (iiib) cash assistance against exports
- (iiic) customs duty or excise repaid or repayable as drawback against exports,
- (iiid) profit on the transfer of DEPB Scheme being the Duty Remission Scheme,
- (iiie) profit on the transfer of DFRC being the Duty Remission Scheme
- (iv) the value of any benefit or perquisite arising from business or the exercise of a profession
- (v) any interest, salary, bonus, commission or remuneration, by whatever name called, received by a partner of the firm from such firm,
- (va) any sum, whether received for (a) not carrying out any activity in relation to any business (b) not sharing any know how, patent, copyright, trade mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services
- (vi) any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy
- (vii) any sum received on account of any capital assets (other than land or goodwill or financial instrument) being demolished, destroyed, discarded or transferred if the whole of the expenditure on such capital assets has been allowed under Section 35AD.

III.248 Auditing Pronouncements

25.3 As per Explanation 2, where speculative transactions constitute a business, such speculation business is deemed to be distinct and separate business from any other business.

25.4 The details of the following claims, if admitted as due by the concerned authorities but not credited to the profit and loss account, are to be stated under sub-clause (b).

- (i) Pro forma credits
- (ii) Drawback
- (iii) Refund of duty of customs
- (iv) Refund of excise duty
- (v) Refund of service tax
- (vi) Refund of sales tax or value added tax

In respect of items falling under sub-clause (b) the tax auditor should examine all relevant correspondence, records and evidence in order to determine whether any particular refund/claim has been admitted as due and accepted during the relevant financial year.

25.5 There may be practical difficulties in verifying the information in regard to such refunds and credits. It may, therefore, be necessary for the tax auditor to scrutinise the relevant files or subsequent records relating to such refunds while verifying the particulars and also obtain an appropriate management representation.

25.6 The words 'admitted by the concerned authorities' would mean 'admitted by the authorities within the relevant previous year'.

25.7 The system of accounting followed in respect of these particular items may also be brought out in appropriate cases. If the assessee is following cash basis of accounting, it should be clearly brought out, since the admittance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed. Credits/claims which have been admitted as due after the relevant previous year need not be reported here.

Where such amounts have not been credited in the profit and loss account but netted against the relevant expenditure/income heads, such fact should be clearly brought out.

25.8 Under sub-clause (c), the escalation claims accepted during the previous year but not credited to the profit and loss account are to be stated. The escalation claims accepted during the year would normally mean "accepted during the relevant previous year". If such amount has not been credited to the profit and loss account the fact should be brought out. The system of accounting followed in respect of this particular item may also be brought out in appropriate cases. If the assessee is following cash basis of accounting with reference to this item, it should be clearly brought out since acceptance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed.

25.9 Escalation claims would normally arise pursuant to a contract (including contracts entered into in earlier years), if so permitted by the contract. Only those claims to which the other party has signified unconditional acceptance could constitute accepted claims. Mere making of claims by the assessee or claims under negotiations or claims which are sub-judice [*CIT v. Hindustan Housing & Land Development Trust Ltd. [1986] 161 ITR 524 (SC)*] cannot constitute claims accepted. The Auditor should take a professional judgment about acceptance of claim based on facts and circumstances of each case.

25.10 Sub-clause (d) covers any other items which the tax auditor considers as an income of the assessee based on his verification of records and other documents and information gathered, but which has not been credited to the profit and loss account. In giving the details under sub-clauses (c) and (d), due regard should be given to AS-9 - Revenue Recognition.

25.11 The tax auditor should scrutinise all the items including casual and nonrecurring items appearing in the books of account, particularly the credit items, and ensure himself whether any such credit which is in the nature of income has been credited to the profit and loss account or not.

25.12 Under sub-clause (e), capital receipt, if any, which has not been credited to the profit and loss account has to be stated. The tax auditor should use his professional expertise and judgement in determining whether the receipt is capital or revenue. The tax auditor may record various judicial pronouncements on which he has relied in his working papers.

25.13 The following is an illustrative list of capital receipts which, if not credited to the profit and loss account, are to be stated under this sub-clause.

- (a) Capital subsidy received in the form of Government grants which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For e.g. Capital Investment Subsidy Scheme.
- (b) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.
- (c) Compensation for surrendering certain rights.
- (d) Profit on sale of fixed assets/investments to the extent not credited to the profit and loss account.

25.14 Loans and borrowings are not required to be stated under this sub-clause.

25.15 If during the course of audit auditor finds that certain income (e.g. income referred to in section 41(1)) are not credited to profit and loss account, the particulars of the same along with the amount is required to be reported under this clause.

III.250 Auditing Pronouncements

26. Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, please furnish:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

(Clause 17)

26.1 Section 43CA is applicable where the assessee has transferred an asset (other than a capital asset) being land or building or both and the value of such an asset is less than the value adopted or assessed or assessable by any State Government authority for the purpose of payment of stamp duty. In such a case for purpose of computing profit & gains from such transfer, the value so adopted or assessed or assessable shall be deemed to be the full value of consideration.

26.2 Section 50C is applicable where the assessee has transferred a capital asset being land or building or both and the value of such an asset is less than the value adopted or assessed or assessable by any State Government authority for the purpose of payment of stamp duty. In such a case, for purpose of section 48, the value so adopted or assessed or assessable by stamp duty authority shall be deemed to be the full value of consideration.

26.3 Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, the auditor is required to furnish the following details:

- (a) Details of property
- (b) Consideration received or accrued
- (c) Value adopted or assessed or assessable

26.4 In the column requiring the details of property, the auditor has to furnish the details about the nature of property i.e. whether the property transferred by him is land or a building along with the address of such property. If the assessee has transferred more than one property, the detail of all such properties is required to be mentioned. The auditor should obtain a list of all properties transferred by the assessee during the previous year. He may also verify the same from the statement of profit and loss or balance sheet, as the case may be. Attention is invited to the meaning of the term "transfer" as defined in section 2(47) of the Act.

26.5 Under the heading "consideration received or accrued", the auditor has to furnish the amount of consideration received or accrued, during the relevant previous year of audit, in respect of land/building transferred during the year as disclosed in the books of account of the assessee.

26.6 For reporting the value adopted or assessed or assessable, the auditor should obtain from the assessee a copy of the registered sale deed in case, the property is registered. In case the property is not registered, the auditor may verify relevant documents from relevant authorities or obtain third party expert like lawyer, solicitor representation to satisfy the compliance of section 43CA/ section 50C of the Act. In exceptional cases where the auditor is not able to obtain relevant documents, he may state the same through an observation in his report 3CA/CB.

26.7 Auditor would have to apply professional judgment as to what constitutes land or building for e.g. whether leasehold right / development rights / TDR / FSI etc would fall under this provisions or not, would require to be evaluated based on facts & circumstances of transactions.

27. Particulars of depreciation allowable as per the Income-tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form:-

- (a) Description of asset/block of assets.**
- (b) Rate of depreciation.**
- (c) Actual cost or written down value, as the case may be.**
- (d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –**
 - (i) Central Value Added Tax credits claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,**
 - (ii) change in rate of exchange of currency, and**
 - (iii) subsidy or grant or reimbursement, by whatever name called.**
- (e) Depreciation allowable.**
- (f) Written down value at the end of the year.**

[Clause 18 (a) to (f)]

27.1 Having regard to the nature of requirements prescribed, it may be necessary for the tax auditor to examine:

- (a) Classification of the asset
- (b) Classification thereof to a block
- (c) The working of actual cost or written down value
- (d) The date of acquisition and the date on which it is put to use
- (e) The applicable rate of depreciation

III.252 Auditing Pronouncements

- (f) The additions / deductions and dates thereof
- (g) Adjustments required – specified as well as on account of sale, etc.

27.2 The word “allowable” implies that depreciation should be permissible as a deduction, as per the provisions of the Act and the Rules. This would require exercise of judgement having regard to the facts and circumstances of the case, developments in law from time to time, etc.

27.3 For the purpose of determining the rate of depreciation, the tax auditor has to examine the classification of the assets into various blocks. For example, a particular asset may be classified as plant or machinery from the viewpoint of one class of assessees, yet it may not be plant or machinery from the viewpoint of another class of assessees. The purpose for which the asset is used is also very material in this regard. Hence, the tax auditor should ensure that the classification as made by the assessee is in consonance with legal principles. In this connection, he should traverse through judicial pronouncements as well as through the past assessment history of the assessee, and upon an analysis thereof, if he comes to the conclusion that the matter is not free from doubt or controversy, he has to indicate the fact in his report by way of suitable qualification. It may also be necessary to rely upon technical data for determining the proper classification of the block. Since the tax auditor is not a technical expert, he has to obtain suitable certificate from concerned experts.

27.4 Once the classification has been ascertained and checked properly, the rates applicable as per the Income-tax Rules, 1962 follow as a natural corollary. The tax auditor must have due regard to the Income-tax Rules, 1962, relevant clarifications from the Department and judicial decisions.

27.5 Under sub-clauses (a) to (b), information in respect of description of assets, block of assets under which the concerned asset is classifiable and the rate of depreciation are to be stated. This will include information about the existing assets. In respect of the existing assets, the computation of depreciation would involve stating the opening written down value of the block of assets which should be taken from the relevant income-tax records. The tax auditor will be conducting the audit in the current year only. As such the tax auditor can rely upon the classification of assets and written down value stated in the income tax records available with the assessee. The tax auditor should mention the fact that he has relied upon the income tax records of the assessee in respect of the information regarding the classification of assets and written down value of the existing assets.

27.6 If there is any dispute with regard to the classification of an asset in a particular block or the rate of depreciation applied, the tax auditor must give his working with suitable reasons. Further, there may be disputes in the earlier years between the assessee and the Department regarding classification, rate of depreciation etc. in respect of which the tax auditor should give suitable disclosure depending upon the facts and circumstances of the case. Alternatively, where the tax auditor adopts a system of classification different from the one adopted by the assessee, suitable disclosure should be made regarding the effect thereof.

27.7 It will, therefore, be advisable to put a suitable note with regard to those items in respect of which disputes for the earlier years are not resolved up to the date of giving the audit report and it should be clarified that the amount of depreciation allowable may change as a result of any decision which may be received after the audit report is given. This note can be in the following manner:

“NOTE: Certain disputes about

- (a) the rate of depreciation on _____
- (b) determination of WDV of block of assets relating to _____ and
- (c) ownership of _____ have arisen in the assessment years _____ for which assessments are pending/appeals are pending. The figures of WDV and/or rate of depreciation mentioned in the above statement may require modification when these disputes are resolved. Therefore, the amount of depreciation allowable as stated in the above statement will have to be accordingly modified.”

27.8 For the purpose of determination of actual cost, the tax auditor has to be guided by the relevant legal provisions. Since determination of actual cost has got accounting implications, he can rely on the relevant Accounting Standards and Guidance Notes. Due to the amendments made by the Finance (No.2) Act, 1998, depreciation is allowable on intangible assets like know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature. There may be intangible assets like patents invented by the company, brand names, etc. for which the assessee might have incurred costs. The tax auditor should examine the basis on which the cost of such intangible assets has been arrived at.

27.9 The additions/deductions during the year have to be reported, with dates. The tax auditor is advised to get the details of each asset or block of asset added during the year or disposed of during the year with the dates of acquisition/disposal. Where any addition was made, the date on which the asset was put to use is to be reported. In respect of deductions, the sale value of the assets disposed of along with dates should be mentioned. The provisions of Section 36(1)(iii) and Explanation 8 to section 43(1) of the Act, should be kept in mind for capitalization of interest to the cost of assets. The tax auditor should check the working regarding the calculation of depreciation allowable under the Act. To ascertain when the asset has been put to use, the tax auditor could call for basic records like production records/installation details/excise records/service tax records/records relating to power connection for operating the machine and any other relevant evidence. In the absence of any specific documentation with regard to the effective date from which the asset is put to use, he could get a representation letter from the management, in respect of the assets acquired. He should examine whether the apportionment of depreciation in cases like succession, amalgamation, demerger etc. has been properly made.

III.254 Auditing Pronouncements

27.10 Section 43(1) of the Act defines actual cost as under :

“Actual Cost” means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority.

Further section 43(1) has explanation from 1 to 13 which provides for different situations for the purpose of calculating the actual cost.

Section 43(2) defines the word “Paid” and Section 43(3) defines the word “Plant”.

Section 2(11) defines “Block of assets” and section 43(6) read with explanations 1 to 7 defines “Written Down Value”.

27.11 The Guidance Note on Accounting for State-level Value Added Tax issued by ICAI has suggested the following treatment in respect of VAT Credit on Capital Goods.

“24. The accounting treatment recommended in the following paragraphs applies only to those capital goods which are eligible for the credit.

25. Paragraph 9.1 of Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the Institute of Chartered Accountants of India, inter-alia, provides as below:

*“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other nonrefundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.
...”*

VAT credit is considered to be of the nature of a refundable tax. Therefore, the tax paid on purchase of capital goods should not be included in the cost of such capital goods.”

In view of above, the VAT Credit eligible on capital goods should be reduced from the cost of the assets for the purpose of claim of depreciation.

27.12 Details have to be given in respect of adjustments on account of three factors. The first adjustment relates to CENVAT claimed and allowed under the Central Excise Rules, 1944 in respect of assets acquired on or after 1st March, 1994. Explanation 9 to section 43(1) of the Act provides that where an asset is or has been acquired on or after the 1st day of March, 1994 by an assessee, the actual cost of asset shall be reduced by the amount of duty of excise or the additional duty leviable under section 3 of the Customs Tariff Act, 1974 (51 of 1975) or Service Tax in respect of which a claim of credit has been made and allowed under the Central Excise Rules, 1944 and Finance Act 1994 (relating to Service Tax) read with CENVAT Credit Rules 2004. It is necessary, therefore, for the tax auditor to examine the details of assets acquired on or after 1st March, 1994 and the details of CENVAT credit claimed and allowed in respect of those assets

27.13 In Clause 18(d)(i) the amount of CENVAT credit claimed and allowed on capital goods

and deducted from the cost of the asset has to be mentioned. Under the CENVAT Credit Rules, 2004, the assessee is entitled to avail credit of duty paid on capital goods and utilise the same, in payment of excise duty leviable on final products, or in payment of service tax on taxable output services. However the CENVAT credit of duty paid on capital goods is not allowed if the assessee claims depreciation under the Act on an amount including the amount of CENVAT credit [Rule 4 (4) of the CENVAT credit rules, 2004].

27.14 As such the assessee should not include duty paid on capital goods eligible for CENVAT credit as part of the cost of fixed assets, otherwise he will not be eligible to claim the CENVAT credit. Whenever, CENVAT credit is rejected in the subsequent year, the auditor should make separate disclosure for the amount of CENVAT credit adjusted during the year which pertains to earlier years. Similarly, if the CENVAT credit is claimed and allowed but which has not been deducted from the cost of the asset, such credit should be deducted from the cost and the appropriate disclosure should be made separately for such adjustment.

27.15 The tax auditor should also verify that the amount of CENVAT credit deducted from cost of capital goods tallies with the credit availed on this account.

27.16 The second adjustment relates to the change in the rate of exchange of currency. Section 43A deals with the adjustment on account of change in the rate of exchange of currency. The Finance Act, 2002 has substituted a new section 43A w.e.f. A.Y. 2002-03. As per this amendment,

- (i) where an assessee has acquired any asset in any previous year from a country outside India for the purposes of his business or profession and,
- (ii) in consequence of a change in the rate of the exchange during any previous year after the acquisition of such asset,
- (iii) there is an increase or reduction in the liability of the assessee as expressed in Indian currency (as compared to the liability existing at the time of acquisition of the asset) at the time of making the payment towards the whole or part of the cost of the asset or towards repayment of the whole or a part of the monies borrowed by him from any person,
- (iv) directly, or indirectly in any foreign currency specifically for the purpose of acquiring the asset along with the interest, if any,
- (v) the increase or reduction in the liability during the previous year which is taken into account at the time of making the payment,
- (vi) irrespective of the method of accounting followed by the assessee, is to be added to, or as the case may be, deducted from the cost of the asset as defined in clause (1) of section 43.

27.17 In other words the extent of addition or reduction will be limited to the exchange difference actually paid during the previous year. The tax auditor is required to verify that the

III.256 Auditing Pronouncements

adjustments in the cost of fixed assets on account of changes in the rate of exchange of currency in the schedule of fixed assets prepared for computation of depreciation as per Income-tax Rules are in accordance with the provisions of section 43A and information about such adjustment is provided under sub-clause (ii) of clause 18(d). The Tax Auditor may also prepare a reconciliation statement for his own records for any different treatment followed for the purpose of books of accounts as per applicable accounting treatment under Accounting Standards. The auditor should also refer the explanations to section 43A.

27.18 The third adjustment relates to the subsidy or grant or reimbursement, by whatever name called. Explanation 10 to section 43(1) provides that where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee. As per the proviso to the above Explanation, where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, such of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement is so received, shall not be included in the actual cost of the asset to the assessee. Subsidy coming within the scope of Explanation 10 to section 43(1) in respect of asset acquired in any earlier year(s) and received during the year has to be deducted from the written down value of such assets in the year of receipt.

27.19 Finally, the amount of depreciation allowable and the WDV at the year end have to be stated. Wherever a claim for depreciation involves any reliance on any judgement or opinion or other contentions (as to its classification, rate applicable, cost, date on which put to use etc.), it may be advisable for tax auditor to disclose full particulars thereof and the basis on which the depreciation allowable has been determined and vouched by him.

27.20 The Finance Act, 2001 had inserted Explanation 5 below sub-section (1) of section 32, to the effect that the provisions of section 32(1) regarding allowing of depreciation shall apply whether or not the assessee has claimed the deduction in respect of depreciation in computing his total income. Thus, the claim for depreciation is now mandatory and the written down value of each asset every year has to be reduced by the amount of depreciation allowable under the Income-tax Rules and the details required under the relevant sub-clauses need to be stated.

27.21 Section 32(1)(ia) effective from Financial year 2002-03 provide for additional depreciation to a concern engaged in the business of manufacturing or production of an article or thing or installation of a new machinery on fulfillment of the prescribed conditions like specified percentage of increase in installed capacity. Additional depreciation shall be allowable in respect of new machinery or plant installed on or after 31st day of March, 2005, which is

- (i) engaged in the business of manufacture or production of any article or thing or
(ii) In the business of generation or generation or distribution of power

except those machinery or plant which before installation by the assessee was used by any other person, machinery or plant installed in office premises or residential accommodation, office appliances, road transport vehicles and that machinery or plant the actual cost of which is allowed in computing the income. The tax auditor will need to verify the claim of additional depreciation under this clause as well.

27.22 Wherever, the full deduction of the cost of capital goods is allowed (e.g. expenditure on Scientific Research u/s. 35) the auditor should verify that the cost of such asset is not included in the block of assets for the purpose of depreciation.

27.23 The tax auditor has to keep in mind the above guidance while furnishing details in respect of this clause in the format provided in the e-filing utility.

28. (a) Amounts admissible under sections:

Section	Amount debited to profit and loss account	Amounts admissible as per the provisions of the Income-tax Act, 1961 and also fulfills the conditions. If any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.
32AC		
33AB		
33ABA		
35(1)(i)		
35(1)(ii)		
35(1)(iia)		
35(1)(iii)		
35(1)(iv)		
35(2AA)		
35(2AB)		
35ABB		
35AC		
35AD		
35CCA		

III.258 Auditing Pronouncements

35CCB		
35CCC		
35CCD		
35D		
35DD		
35DDA		
35E		

[Clause 19]

28.1 The assessee can claim deduction under the sections 32AC, 33AB, 33ABA, 35, 35ABB, 35AC, 35AD, 35CCA, 35CCB, 35CCC, 35CCD, 35D, 35DD, 35DDA and 35E subject to the terms and conditions mentioned in these Sections.

28.2 In case the assessee has obtained a separate Audit Report for claiming deductions under any of these sections, he must make a reference to that report while giving the details under this clause.

28.3 The Tax Auditor should indicate the amount debited to the Profit & Loss Account and the amount actually admissible in accordance with the applicable provisions of law.

28.4 The amount not debited to the Profit & Loss Account but admissible under any of the Sections mentioned in the clause have to be stated. For example sections 33AB and 33ABA allow deduction in respect of amount deposited in designated account for specified purposes which, as per accounting principles, are not to be debited to the Profit & Loss Account. In this connection, the Tax Auditor has to work out, on the basis of the conditions prescribed in the concerned Section, the amount admissible there under and report the same.

28.5 An assessee may be eligible for deduction under one or more sub-sections of section 35. In such case, the Tax Auditor should state the deduction allowable under each sub-section separately under applicable part, i.e. the amount deductible in respect of the amount debited in Profit & Loss Account and the amount not debited to the Profit & Loss Account.

28.6 The Tax Auditor should also ensure the eligibility of the expenditure/payment for deduction and compliance of the conditions prescribed in the sub-section including approval from the relevant/prescribed authority, notification issued by the Central Government, any other guideline circular etc issued in this behalf. Tax auditor should also refer Rule 6 of Income-tax Rules, 1962.

28.7 In case the auditor relies on a judicial pronouncement, he may mention the fact in his observations para provided in Form No.3CA or Form No.3CB, as the case may be.

28.8 The following Table summarizes Sub-section-wise eligibility, requirement of compliance of the conditions and the amount of deductions required to be mentioned under this clause

(The summary is only illustrative and Tax Auditor is advised to refer actual provision of the Act):

Table showing deductions applicable from A.Y. 2014-15 onwards (as per law prevailing on 1-4-2014)

Section & Sub-section	Eligible expenditure/payment	Amount/Quantum of Deduction
32AC	Investment in New Plant & Machinery	15% of the actual cost of such new assets.
33AB	Amount deposited in Tea/Coffee/Rubber Development Account	Deduction is allowed for the least of the following: (a) Sum equal to the amount or the aggregate of the amounts so deposited.(b) Sum equal to 40% of the profits of such business.
33ABA	Where an amount is being deposited by an assessee in a scheme approved by the Government of India in the Ministry of Petroleum and Natural Gas for the purpose of prospecting or extraction etc. of petroleum or natural gas.	Deduction is allowed for the least of the following: (a) Sum equal to the amount or the aggregate of the amounts so deposited. (b) Sum equal to 20% of the profits of such business
35(1)(i)	Any Expenditure other than Capital Expenditure incurred by the assessee for scientific research related to its own business.	100% of the expenditure
35(1)(ii)	Amount paid to Research association which has as its object the undertaking of scientific research Or amount paid to a University, college or other institutions to be used for scientific research. Provided that, such association, university, college or other institution is approved and is specified as such, by notification in the	175% of amount paid/contributed from A.Y. 2011-12 and onwards 125% of amount paid/contributed till A.Y 2010-11.

III.260 Auditing Pronouncements

Section & Sub-section	Eligible expenditure/payment	Amount/Quantum of Deduction
	official gazette, by Central Govt.	
35(1)(ia)	Amount paid to a Company which is registered in India, having its main object of carrying out of scientific research and development and is approved by the jurisdictional Chief Commissioner of Income Tax in the prescribed manner.	125% of amount paid from A.Y. 2009-10
35(1)(iii)	Amount paid to a research association which has as its main object the undertaking of research in social science or statistical research Or Amount paid to a university, college or other institutions to be used for research in social science or statistical research. Provided that, such association, university, college or other institution is approved and is specified as such, by notification in the official gazette, by Central Govt.	125% of amount paid.
35(1)(iv)	Expenditure of capital nature on scientific research, other than expenditure on acquisition of any land, incurred related to the business carried on by the assessee.	100% of the capital expenditure incurred
35(2AA)	Any amount paid to National Laboratory; or a University; or Indian Institute of Technology or specified person as defined in the explanation 2 to the section with a specific direction that the said sum shall be used for scientific research undertaken under a programme approved by the prescribed authority.	200% of amount paid from A.Y. 12-13 and onwards. 175% for A.Y.2011-12 125% till A.Y.2010-11
35(2AB)	Deduction is available only to company (refer section 2 (17) of Income Tax Act, 1961) (Applicable from 01/04/2009 i.e. A.Y 2010-11 & onwards)	200% of Expenditure incurred from A.Y. 2011-12 and onwards. 150% of Expenditure incurred from A.Y. 2001-02 to A.Y. 2011-12 125% till A.Y. 2000-01.

Section & Sub-section	Eligible expenditure/payment	Amount/Quantum of Deduction
	<p>From A.Y. 2012-13 and onwards: Company engaged in the business of Bio Technology or in any business of manufacture or production of any article or thing, not being an article or thing specified in the list of the Eleventh Schedule.</p> <p>Upto A.Y. 2011-12: Finance Act, 2009, i.e. from A.Y. 2010-11 provides that, company engaged in the business of business of manufacture or production of any drugs, pharmaceuticals, electronic equipments, computers, telecommunication equipments, chemicals or any other article or thing notified by the Board.</p> <p>Expenditure incurred both revenue and capital, not being expenditure in the nature of cost of any land or building; on in house research and development facility as approved by the prescribed authority. Expenditure incurred in relation to drugs and pharmaceuticals shall include expenditure on clinical drug trial, for regulatory approvals and filling an application for patent.</p> <p>Prescribed authority is Secretary, Department of Scientific and Industrial Research.</p>	
35ABB	Any expenditure, being in the nature of capital expenditure incurred for acquiring any right to operate telecommunication services[either before the commencement of the business to operate telecommunication services or thereafter at any time during any previous year]	<p>Deduction equal to the appropriate fraction of the amount of such expenditure.</p> <p>Where “appropriate fraction” means the fraction the numerator of which is one and the denominator of which is</p>

III.262 Auditing Pronouncements

Section & Sub-section	Eligible expenditure/payment	Amount/Quantum of Deduction
		the total number of the relevant previous years;
35AC	Expenditure by way of payment of any sum to a public sector company or a local authority or to an association or institution approved by the National Committee for carrying out any eligible project or scheme	100% of such expenditure
35AD	Deduction in respect of any expenditure of capital nature incurred wholly & exclusively for any specified business.	<p>Setting up and Operating cold chain facility-150% of expenditure</p> <p>Setting up and Operating warehousing facility for storage of Agriculture produce-150% of expenditure</p> <p>Laying and operating a cross country natural gas pipeline network for distribution-100% of expenditure</p> <p>Building and operating a new Hotel in India, of two star or above category- 100% of such expenditure</p> <p>Building and operating a new Hospital in India, with at least one hundred beds for patients- 150% of expenditure</p> <p>Developing and building a housing project under a scheme for slum rehabilitation-100% of expenditure</p> <p>Developing and building a housing project under a scheme for affordable</p>

Section & Sub-section	Eligible expenditure/payment	Amount/Quantum of Deduction
		<p>housing-150% of expenditure</p> <p>Production of fertilizer in India-150% of expenditure</p> <p>Setting up and operating an inland container depot or a container freight station-100% of expenditure</p> <p>Bee-keeping and production of honey and beeswax-100% of expenditure</p> <p>Setting up and operating a warehousing facility for storage of sugar-100% of expenditure</p> <p>Laying and operating a slurry pipeline for the transportation of iron ore – 100% of expenditure w.e.f AY 2015-16</p> <p>Setting and operating a semi-conductor wafer fabrication manufacturing unit – 100% of expenditure wef AY 2015-16</p>
35CCA	Expenditure by way of payment to association and institutions for carrying out rural development programmes	100% of expenditure
35CCB	Expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources	100% of expenditure
35CCC	Expenditure on agricultural extension project notified by the Board	150% of expenditure

III.264 Auditing Pronouncements

Section & Sub-section	Eligible expenditure/payment	Amount/Quantum of Deduction
35CCD	Expenditure incurred by a company on any skill development project notified by the Board	150% of expenditure
35D	Expenditure incurred by an Indian Company or a person who is resident in India on amortization of certain preliminary expenses.	One tenth of such expenditure for each of the ten successive previous years beginning with the previous year in which business commences or as the case may be.
35DD	Amortisation of Expenditure incurred by an Indian Company for the purpose of amalgamation or demerger	One fifth of such expenditure for each of the five successive previous years beginning with the previous year in which amalgamation or demerger takes place.
35DDA	Expenditure incurred by way of payment of any sum to an employee in connection with his voluntary retirement, in accordance with any scheme or scheme of voluntary retirement.	One-fifth of the amount so paid shall be deducted in computing the profits and gains of the business for that previous year, and the balance shall be deducted in equal installments for each of the four immediately succeeding previous years.
35E	Deduction for expenditure on prospecting or extraction or production of certain minerals.	One tenth of amount of such expenditure for each of ten successive previous years.

Members are advised to refer the Income-tax Act, 1961 for any change in the provisions of Act at the time of signing the audit report.

28.8 Where under any section an assessee is eligible for deduction under one or more of the sub-sections of the said section, the Tax Auditor should certify the amount of deduction

available under each sub-section separately in the applicable part, i.e. the amount deductible in respect of the amount debited to Profit & Loss Account and the amount not debited to the Profit & Loss Account.

29. (a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)].

(b) Details of contributions received from employees for various funds as referred to in section 36(1)(va):

Serial number	Nature of fund	Sum received from employees	Due date for payment	The actual amount paid	The actual date of payment to the concerned authorities

[Clause 20 (a) and (b)]

29.1 Section 36(1)(ii) provides for deduction of any sum paid to an employee as bonus or commission for services rendered where such sum would not have been payable to him as profit or dividend, if it had not been paid as bonus or commission. In other words, if bonus or commission is in the nature of profit or dividend, it may not be normally allowable as a deduction unless such payment is wholly and exclusively made to the employee. [*Shahzada Nand & Sons v. CIT [1977] 108 ITR 358 (SC)*].

29.2 Under Clause 20(b), the requirement is only in respect of the disclosure of the amount and the tax auditor is not expected to express his opinion about its allowability or otherwise. The tax auditor should verify the employment/ contract details of the employees so as to ascertain the nature of payments.

29.3 Section 36(i)(va) of the Act permits deduction of any sum received by the assessee from any of his employees to which the provisions of section 2(24)(x) are applicable, if it is credited by the assessee to the account of the employees in the relevant statutory fund on or before the due date.

29.4 Section 2(24)(x) includes within the scope of income any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or ESI Fund or any other Fund for employees' welfare (hereafter referred to as "Welfare Fund").

29.5 As per the explanation provided in section 36(1)(va), "due date" means the date by which the assessee is required as an employer to credit an employee's contribution to the employee's account in the relevant fund under any Act., rule, order or notification issued there under or under any standing order, award, contract of service or otherwise, i.e., the date by

III.266 Auditing Pronouncements

which it is required to be credited as per the provisions of the applicable law etc. It may be noted that Employees' P.F. manual provides for 5 days of grace period for payment of contribution. This can be taken into consideration for determining the due date of payment.

29.6 The tax auditor should get a list of various contributions recovered from the employees which come within the scope of this clause and the date on which it is deposited. He should also verify the documents relating to provident funds and other welfare funds. He should verify the agreement under which employees have to make contributions to provident fund and other welfare funds. The ledger account of contributions from employees should be reviewed; the due dates of payments and the actual dates of payment should be verified with the evidence available. In view of the voluminous nature of the information, the tax auditor can apply test checks and compliance tests to satisfy himself that the system of recovery and remittance is proper. Under this clause, details regarding the nature of fund, details of the amount deducted, due date for payment, actual amount paid and actual date of payment to the concerned authorities in respect of provident fund, ESI fund or other staff welfare fund have to be stated.

29.7 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

(a)

Description	Amount
1	2

(b)

Serial number	Nature of fund	Sum received from employees	Due date for payment	The actual amount paid	The actual date of payment to the concerned authorities
1	2	3	4	5	6

30. (a) Please furnish the details of amounts debited to the profit and loss account, being in the nature of Capital, personal, advertisement expenditure etc:

[Clause 21(a)]

Nature	Serial number	Particulars	Amount in Rs.
Capital Expenditure			
Personal Expenditure			
Advertisement expenditure in any souvenir, brochure, tract, pamphlet or the like published by a political party			
Expenditure incurred at clubs being entrance fees and subscriptions			
Expenditure incurred at clubs being cost for club services and facilities used.			
Expenditure by way of penalty or fine for violation of any law for the time being force			
Expenditure by way of any other penalty or fine not covered above			
Expenditure incurred for any			

III.268 Auditing Pronouncements

purpose which is an offence or which is prohibited by law			

31. (b) Amounts inadmissible under section 40(a):
- (i) as payment to non-resident referred to in sub-clause (i)
- (A) Details of payment on which tax is not deducted:
- (I) date of payment
 - (II) amount of payment
 - (III) nature of payment
 - (IV) name and address of the payee
- (B) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)
- (I) date of payment
 - (II) amount of payment
 - (III) nature of payment
 - (IV) name and address of the payee
 - (V) amount of tax deducted
- (ii) as payment referred to in sub-clause (ia)
- (A) Details of payment on which tax is not deducted:
- (I) Date of payment
 - (II) Amount of payment
 - (III) Nature of payment
 - (IV) Name and address of the payee
- (B) Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub-section (1) of section 139.
- (I) Date of payment
 - (II) Amount of payment
 - (III) Nature of payment
 - (IV) Name and address of the payer*
 - (V) Amount of tax deducted

- (VI) Amount out of (V) deposited, if any
- (iii) Under sub-clause (ic) [wherever applicable]
 - (iv) Under sub-clause (iia)
 - (v) Under sub-clause (iib)
 - (vi) Under sub-clause (iii)
 - (A) Date of payment
 - (B) Amount of payment
 - (C) Name and address of the payee
 - (vii) Under sub-clause (iv)
 - (viii) Under sub-clause (v)

* should be read as “payee” for proper reporting

[Clause 21(b)]

32. (c) Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;

[Clause 21(c)]

33. (d) Disallowance/deemed income under section 40A(3):
- (A) On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:

Serial number	Date of payment	Nature of payment	Amount	Name and Permanent Account Number of the payee, if available

- (B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);

III.270 Auditing Pronouncements

Serial number	Date of payment	Nature of payment	Amount	Name and Permanent Account Number of the payee, if available

[Clause 21(d)]

34. (e) provision for payment of gratuity not allowable under section 40A(7);
[Clause 21(e)]

35. (f) any sum paid by the assessee as an employer not allowable under section 40A(9);
[Clause 21(f)]

36. (g) particulars of any liability of a contingent nature;
[Clause 21(g)]

37. (h) amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income
[Clause 21(h)]

38. (i) amount inadmissible under the proviso to section 36(1)(iii)
[Clause 21(i)]

30. Clause 21

This clause requires the tax auditor to state the amount of expenditure incurred by the assessee in respect of various items listed above. These expenses may be allowable or may not be allowable or may be allowable subject to certain limits. It is important to note that the amount of expenditure in respect of each of the items is required to be stated. Accordingly, tax auditor will have to obtain the information and make necessary enquiries in that behalf. It will necessitate verification of books of account and other relevant documents, basis of classification, groups under which such expenses have been debited, and so on.

30.1 Clause 21(a) - Expenditure in the nature of capital, personal, advertisement expenditure etc.

Expenditure of Capital nature:

Capital expenditure is not allowable in computing business income unless specifically provided in any sections of the Act. The word "capital expenditure" is not defined in the Act and no conclusive test or rules can be laid down to determine whether a particular expenditure is capital or revenue in the nature. Different tests have been applied by the courts in different

cases depending upon the facts and circumstances of each case and the case law on the subject, as evolved over a period of years, gives guidance for determining the nature of expenditure.

30.2 Some tests which, however, are generally applied to determine whether a particular item of expenditure is of capital nature, are set out hereunder:

- (i) Whether it brings into existence an asset or advantage of enduring benefit. The question whether a particular benefit is of an enduring or permanent nature will depend upon the facts and circumstances of each case, the concept of permanency being relative.
- (ii) Whether it is referable to fixed capital or fixed assets in contrast to circulating capital or current assets.
- (iii) Whether it relates to the basic framework of the assessee's business.
- (iv) Whether it is an expenditure to acquire an intangible asset.

30.3 The above factors are not exhaustive and the tax auditor is required to verify the expenditure based on facts of the case after considering the applicable provisions of the Act.

30.4 The nature of receipt in the hands of the recipient is not a determining factor to decide the nature of payment in the hands of payer. If the amount is in the nature of capital receipt in the hands of the payee, it does not necessarily imply that it is a capital expenditure for the payer and vice versa. The case of the payer has to be considered independently based on the facts concerning him.

30.5 Under the Act, capital expenditure of certain types e.g., on scientific research referred to in section 35, is deductible in computing the income. Similarly depreciation at 100% is allowed in respect of certain assets as prescribed in New Appendix I of the Income-tax Rules, 1962. Ordinarily the capital expenditure should not be debited to profit and loss account. The tax auditor needs to keep in mind that the accounting standards also apply in respect of financial statements audited under section 44AB of the Act. Therefore, besides disclosing the amount of such capital expenditure debited to profit and loss account under this clause, the tax auditor should give suitable disclosure/ qualifications in para 3(a) of Form No. 3CB, depending on the facts of the case.

30.6 The details of capital expenditure, if any, debited to the profit and loss account should be maintained in a classified manner stating the amount under various heads separately. Since part of this capital expenditure may be allowable as deduction in the computation of total income, it is advisable to maintain particulars regarding the nature of expenditure, the amount of expenditure incurred, and the relevant provision under which the expenditure is admissible. However, the total amount of capital expenditure debited to the profit and loss account is to be reported under this clause in the e-filing portal.

III.272 Auditing Pronouncements

Expenditure of personal nature:

30.7 Personal expenses debited to the profit and loss account are to be specified under this sub-clause as they are not deductible in the computation of total income under section 37. It may be noted that the word “personal” is confined to and attached with the “assessee” and not necessarily to and with persons other than the assessee.

30.8 Section 143(1)(e) of the Companies Act 2013 specifically requires the auditor to inquire whether personal expenses have been charged to revenue account. In the case of a person whose accounts of the business or profession have been audited under any other law, the tax auditor will have to report in respect of personal expenses debited in the profit and loss account. In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the tax auditor will have to verify the personal expenses if debited in the expenses account while conducting the audit and verify the amount of expenses mentioned under this clause.

30.9 The tax auditor is advised to maintain the following details as part of his working papers for the purpose of reporting in the format provided in the e-filing utility:

Sl. No.	Nature and particulars of expenditure	Account head under which debited	Amount of expenditure	Remarks
1	2	3	4	5

Expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party:

30.10 Section 37(2B) provides that no allowance shall be made in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party. Therefore, the expenditure of this nature should be segregated and reported under this clause.

30.11 The tax auditor may come across advertising expenditure incurred on advertising in a souvenir, brochure, tract, pamphlet or journal published by a trade union or a labour union formed by a political party. The trade union or labour union though promoted or formed by a political party may have a distinct legal entity. In that event, expenditure incurred by the assessee by way of advertisement given in the souvenir, brochure, tract, pamphlet or journal published by the trade union or the labour union is not required to be indicated against clause 21(a) in Form No. 3CD. If the trade union or labour union formed by the political party does not have a separate and distinct legal entity, then the expenditure incurred on such an advertisement will have to be indicated against this clause.

30.12 The auditor may also keep in mind the provisions of section 80GGB and 80GGC which allow deduction in respect of contribution made by corporate and non-corporate assesseees

respectively to political parties and electoral trust, as required to be reported by him in clause 33 of Form no. 3CD.

Expenditure incurred at clubs being cost for club services and facilities used, entrance fees and subscriptions:

30.13 The amount of payments made to clubs by the assessee during the year being cost for club services and facilities used should be indicated under this clause. The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 21(a) referred to earlier.

30.14 Details of payments made to clubs are also required by tax authorities for the purpose of determining whether any portion of club expenses could be treated as perquisite in the hands of the person concerned. All payments made to credit card agencies should be carefully scrutinised. Credit card agency is nothing but credit/collecting agency. In order to determine whether the payments have been made to a club, one has to look into the substantive activity of the institution concerned.

30.15 This clause requires reporting of particulars and the amount of such expenses incurred in the respective fields. However, the following particulars may be maintained as working papers by the auditor for the purpose of reporting in the format provided in the e-filing utility:

Sr. No.	Name of the Club	Nature of Amount paid			Remarks
		Entrance/admission Fees	Subscription expenses	Cost of Club Services and facilities used	
(1)	(2)	(3)	(4)	(5)	(6)

Expenditure by way of penalty or fine for violation of any law for the time being in force; Expenditure by way of penalty or fine not covered above; Expenditure incurred for any other purpose which is an offence or is prohibited by law:

30.16 This clause requires separate reporting of penalty or fine for violation of any law for the time being in force, and any other penalty or fine. The tax auditor should obtain in writing from the assessee the details of all payments by way of penalty or fine for violation of any laws have been made and paid or incurred during the relevant previous year and how such amounts have been dealt with in the books of accounts produced for audit.

30.17 The tax auditor may not be an expert to decide the nature of payment (as to whether it is prohibited by law or not) and may not be aware of the intricacies of all the laws of the land. He can rely on the expert opinion. It must be borne in mind that the tax auditor while reporting

III.274 Auditing Pronouncements

under this clause is not required to express any opinion as to the allowability or otherwise of the amount of penalty or fine for violation of law. He is only required to give the details of such items as have been charged in the books of accounts. This clause covers only penalty or fine for violation of law and not the payment for contractual breach or liquidator damages. The tax auditor should keep in mind the difference between the amount prohibited by law and the amount paid which is compulsory in nature under the relevant statute. While stating the particulars under this clause, the tax auditor should also take into consideration the concept of materiality.

30.18 In order to ascertain the facts whether the sum debited in the profit and loss account is by way of penalty or fine for any violation of law, the tax auditor will have to refer to the relevant law under which the amount has been paid or incurred and ascertain whether such amount is in the nature of penalty or fine. He should also ascertain all the facts by having recourse to the order of the jurisdictional authority which has levied the penalty or fine. Even if the assessee is contesting against such order before higher authorities, the same will not be relevant and the mere point for ascertaining is whether such sum is debited to the profit and loss account and if yes, the same has to be disclosed.

30.19 The courts have laid down that any penalty or fine for violation of law is not admissible as expenditure. It is in this context the requirement stipulated by clause 21(a) is to be answered.

30.20 The following Explanation to section 37(1) of the Act has been inserted by Finance Act (No.2) Act, 1998 with effect from assessment year 1962-63.

"For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure".

30.21 Under this sub-clause, any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law is to be stated.

30.22 Any expenditure in consequence of violation of law like penalty or fine levied for evading provisions of the Act, FEMA, Excise and Customs law etc., cannot be claimed as deduction under the Act. A penalty imposed for violation of any law during the course of trade cannot be described as a commercial loss. Even if the need for making payments has arisen out of trading operations, the payments are not wholly and exclusively for the purpose of the trade. Violation of law is not a normal incidence of business. This principle was laid down by Hon'ble Supreme Court in case of *CIT v. Maddi Venkataratnam & Co. (P) Ltd [1998] 96 Taxman 643* and in the case of *Hazi Aziz Shekoo Bros v. CIT [1961] 41 ITR 350*. In both the cases it was held that one can carry business or his trade without violating the law.

30.23 In *Prakash Cotton Mills (P) Ltd. v CIT [1993] 201 ITR 684 (SC)* it has been held that whenever any statutory impost paid by an assessee by way of damages or penalty or interest

is claimed as an allowable expenditure under section 37(1) of the Act, the assessing authority is required to examine the scheme of the provisions of the relevant statute providing for payment of such impost notwithstanding the nomenclature of the impost as given by the statute, to find whether it is compensatory or penal in nature.

30.24 The authority has to allow deduction under section 37(1) wherever such examination reveals the concerned impost to be purely compensatory in nature. Wherever such impost is found to be of a composite nature, that is, partly of compensatory nature and partly of penal nature, the authority would have to bifurcate the two components of the impost and give deduction of that component which is compensatory in nature and refuse to give deduction of that component which is penal in nature. The above principle was reiterated in the case of *Swadeshi Cotton Mills (1998) 233 ITR 199*.

30.25 Further, in *CIT v Ahmedabad Cotton Mfg. Co. Ltd. [1993] 205 ITR 163(SC)*, the Supreme Court held that what needs to be done by an Assessing Authority under the Act, in examining the claim of an assessee that the payment made by such assessee was a deductible expenditure under section 37 although called a penalty, is to see whether the law or scheme under which the amount was paid, required such payment to be made, as penalty or as something akin to penalty, that is, imposed by way of punishment for breach for infraction of the law or the statutory scheme. If the amount so paid is found to be not a penalty or something akin to penalty due to the fact that the amount paid by the assessee was in exercise of the option conferred upon him under the levy, law or scheme concerned, then one has to regard such payment as business expenditure of the assessee, allowable under section 37 as incidental to business laid out and expended wholly and exclusively for the purposes of the business.

30.26 In case of *Malwa Vanaspati & Chemical Co. v. CIT [1997] 225 ITR 383(SC)*, it was held that where the assessee is required to pay an amount comprising both the elements of compensation and penalty, the compensation is allowable as business expenditure, but not the penalty.

30.27 Where the penalty or fine is in the nature of penalty or fine only, the entire amount thereof will have to be stated. As discussed above, with reference to certain penalty/penal interest courts have held that it is partially compensatory payment and partially in the nature of penalty. In such a case, on the basis of appropriate criteria, the amount charged will have to be bifurcated and only the amount relating to penalty may be stated.

31. Clause 21(b) - amounts inadmissible under section 40(a)

31.1 This clause is substantially expanded to furnish detailed information for deduction and deposit of TDS. Section 40(a) specifies certain amounts which shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession". The relevant provisions for A.Y. 2014-15 are as under:

- (i) **Non-Resident Payments:** Any interest, royalty, fees for technical services or other sum

III.276 Auditing Pronouncements

chargeable under the Income-tax Act which is payable outside India or in India to a non-resident or a foreign company on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid during the previous year or in the subsequent year before the expiry of the time prescribed under sub section (1) of section 200.

Provided that where in respect of any such sum, tax has been deducted in any subsequent year or, has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under sub-section (1) of section 200, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

Finance Act, 2014 has amended section 40(a)(i) to provide that if the tax deducted is paid during the previous year or in the subsequent year before the expiry of time prescribed for filling the tax return u/s. 139(1), the same shall be allowed as deduction in the previous year in which the tax is deducted.

- (ii) **Resident Payments:** Any interest, commission or brokerage, rent, royalty, fees for professional services or fees for technical services payable to a resident or amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply or labour for carrying out any work) on which tax is deductible at source under chapter XVII-B and such tax has not been deducted or after deduction has not been paid on or before the due date specified in section 139(1).

As per first proviso to Section 40(a)(ia), where tax is deducted in any subsequent year, or has been deducted during the previous year but paid after the due date specified in section 139(1), the expenditure is allowable as a deduction in the year in which such tax has been paid. The Finance Act 2012, inserted second proviso in section 40(a)(ia) with effect from 01-04-2013 (A.Y.2013-14) as a consequence to amendment in Section 201. The second proviso provides that where an assessee fails to deduct the whole or any part of the tax in accordance with the provisions of Chapter XVII-B on any such sum but is not deemed to be an assessee in default under the first proviso to sub-section (1) of section 201, then, for the purpose of clause (ia) of section 40(a), it shall be deemed that the assessee has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee referred to in the said proviso.

- (iii) Any sum paid on account of wealth tax.
- (iv) The Finance Act, 2013 inserted a sub-clause (iib) in section 40(a) with effect from A.Y. 2014-15. Accordingly, any amount paid by way of a Royalty, License Fees, Service Fees, Privilege Fees, Service Charges or any other fees or charge by whatever name called, which is levied exclusively on or which is appropriated directly or indirectly from a State Government undertaking by the State Government shall not be allowed as a deduction from the income under the head "profit and gains from business or profession".

- (v) Any payment which is chargeable under the head “salaries”, if it is payable outside India or to a non-resident and if the tax has not been paid thereon nor deducted therefrom under Chapter XVII-B.
- (vi) Any payment to a provident or other fund established for the benefit of employees of the assessee, unless the assessee has made effective arrangement to secure that tax shall be deducted at source from any payment made from the fund which are chargeable to tax under the had “Salaries”.
- (vii) Any tax actually paid by an employer referred to in clause (10CC) of section 10.

31.2 The Finance (No.2) Act, 2014 has amended the provisions of section 40(a)(ia) w.e.f. AY 2015-16 to disallow only 30% of any sum payable to a resident on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid on or before the due date specified under section 139(1). The first proviso to section 40(a)(ia) has also been amended to provide that where any sum on which tax has been deducted in any subsequent year, or has been deducted during the previous year but paid after the due date specified in sub-section (1) of section 139, thirty percent of such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

31.3 In respect of item (i) and (vi) above, the tax auditor should obtain in writing from the assessee the details of all payments debited to the profit and loss account. Where an actual remittance overseas has been made by the assessee during the relevant previous year without deducting any tax at source, the tax auditor may rely upon the legal opinion and/or certificates from chartered accountants based upon which remittances have been made without deduction of tax at source.. The tax auditor may refer SA 620, *Using the work of an auditor's expert* issued by ICAI for reliance on certificates / legal opinion. In this connection the tax auditor is advised to refer the applicable Double Taxation Avoidance Agreement (DTAA). Where no remittances have been made during the relevant year, the tax auditor may examine the relevant provisions vis-à-vis the agreement or correspondence in pursuant to which the liability is provided by the assessee in his books of account in order to determine whether any amount so provided is at all chargeable to tax under the Act. The tax auditor may use his professional judgement in these matters based upon decided cases and he may rely upon a legal opinion obtained by the assessee where no tax is required to be deducted in respect of the amount so provided. In case he disagrees with the stand taken by the assessee, he should give both the views in his report.

31.4 Under clause 21(b)(i)(A), the auditor is required to report payments to non residents on which tax is required to be deducted but not deducted in respect of interest, royalty, fees for technical services and other such chargeable amount under the Income tax Act. The Auditor is advised to give details under this clause for each individual payee.

31.5 Similarly under clause 21(b)(i)(B), the auditor is required to report payments on which tax is deducted but is not deposited within the time prescribed during the previous year or in

III.278 Auditing Pronouncements

subsequent year. Such details are also required to be given for each individual payee prescribed under Section 40(a)(i).

31.6 Under this sub-clause the tax auditor is required to report the details of payment on which tax is not deducted at source and also the details of payment on which tax has been deducted but not paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)/139(1). The tax auditor should maintain the following data in his working papers for the purpose of reporting under this sub-clause:

(a) Details of payment on which tax was not deducted:

Sr. No	Date of payment	Amount of payment	Nature of payment	Name and address of the payee	PAN of the payee, if available
1	2	3	4	5	6

(b) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)/139(1):

Sr. No.	Date of payment	Amount of payment	Nature of payment	Name and address of the payee	PAN of the payee, if available	Amount of tax deducted
1	2	3	4	5	6	7

31.7 With the introduction of clause (ia) in section 40(a), the scope of disallowance of the expenditure has been widened to include interest, commission, brokerage, rent, royalty, fees for professional services or fees for technical services payable to a resident or amounts payable to a contractor or subcontractor, being resident for carrying out any work including supply of labour for carrying out any work. Under this sub-clause any payment of the expenses, specified therein on which tax is deductible under Chapter XVIIIB and such tax has not been deducted or after deduction has not been paid on or before the date of filing of return specified under section 139(1), is not eligible for deduction while computing income chargeable under the head "profits and gains of business or profession". Accordingly, such amount will be inadmissible and will be required to be disclosed under this clause. For this purpose the tax auditor will be required to examine whether the provisions relating to tax deduction at source have been complied with in respect of payments specified under the clause. For this purpose the tax auditor may examine the books of accounts and tax deduction returns pertaining to these payments.

31.8 Where the auditee claims deduction under the second proviso to sub-section (ia) it is deemed that he has deducted and paid the tax and hence such sum on which tax is so deemed to be deducted and paid is not inadmissible, the tax auditor should verify compliance with the requirements of section 201. He should also obtain and keep in his record a copy of certificate in Form 26A as required by section 201 read with section 40(a)(ia).

31.9 Under clause 21(b)(ii)(A), auditor is required to report payments to residents on which tax is required to be deducted but not deducted in respect of interest, royalty, fees for technical services and other such chargeable under Chapter XVII-B of the Income Tax Act. The auditor is advised to give details under this clause for each individual payee.

31.10 Similarly under clause 21(b)(ii)(B), auditor is required to report payments on which tax is deducted but is not deposited within the time prescribed during the previous year or in subsequent year. Such details are also required to be given for each individual payee prescribed under section 40(a)(ia).

31.11 Tax auditor should also verify that the particulars given under this clause do not differ from the particulars given under clause 34 of Form no. 3CD to the extent applicable. Under this sub-clause, the tax auditor is required to report the details of payment on which tax is not deducted at source and also the details of payment on which tax has been deducted but not paid on or before the due date specified in section 139(1). The tax auditor should maintain the following data in his working papers for the purpose of reporting under this sub-clause:

(a) Details of payment on which tax was not deducted:

Sr. No	Date of payment	Amount of payment	Nature of payment	Name and address of the payee	PAN of the payee, if available
1	2	3	4	5	6

(b) Details of payment on which tax has been deducted but has not been paid on or before the due date specified under section 139(1):

Sr. No.	Date of payment	Amount of payment	Nature of payment	Name and address of the payee	PAN of the payee, if available	Amount of tax deducted	Amount out of (5) deposited, if any
1	2	3	4	5	6	7	8

31.12 The Item no. (iii) of clause 21(b) requires reporting of any sum paid on account of fringe benefit tax under Chapter XIIH, wherever applicable. Since Fringe benefit tax was abolished by the Finance (No.2) Act, 2009 with effect from 1-04-2009, the tax auditor will be required to furnish information under this item only if the audit report relates to an assessment year to which the provisions of chapter XII H were applicable. For all other cases, the tax auditor may report "NIL" or "Not Applicable" as per the requirement of the format of e-filing utility. The provision relating to Fringe Benefit Tax (FBT) has been omitted from A.Y. 2010-11. If any such tax is paid during the year, the same is not allowed as deduction u/s. 40(a)(i)(c). The auditor is required to report such amount of tax paid under clause 21(b)(iii), if any liability has been incurred due to any order of any authority up to AY 2010-11 .

III.280 Auditing Pronouncements

31.13 The amount of Wealth Tax paid is not allowed as a deduction u/s. 40(a)(iia) and thus is required to be reported under clause 21(b)(iv).

31.14 Finance Act, 2013 inserted new sub clause 40(a)(iib) w.e.f. A.Y. 2014-15 to provide that (a) any amount paid by way of a royalty, license fees, service fees, privilege fees, service charge or any other fees or charge by whatever name called, which is levied exclusively on; or (b) which is appropriated, directly or indirectly from, a State Government undertaking by the State Government is inadmissible expenditure. The explanation to this sub clause (iib) also defines a State Government undertaking. The Tax auditor should verify any such payment made by State Government undertaking to the State Government and should report under clause 21(b)(v).

31.15 The amount of salary which is paid outside India or to a non-resident in respect of which tax has not been deducted but which is required to be deducted under the applicable provisions of the Income Tax Act or tax has not been paid after deduction, the same is not allowed as a deduction u/s. 40(a)(iii) and the same is required to be reported under clause 21(b)(vi). This information is required to be given for each individual payee. The tax auditor should also furnish the date of payment along with the name and address of the payee. The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

Sr No.	Date of payment	Amount of payment	Name of payee	PAN of the payee, if available	Address
1	2	3	4	5	6

31.16 Section 40(a)(iv) provides that any payment to a provident or other fund established for the benefit of employees of the assessee shall be disallowed, unless the assessee has made effective arrangements to secure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head "Salaries". The auditor is also required to report the same under item (vii) of this sub-clause.

31.17 Any tax paid by an employer on non-monetary perquisites is exempt in the hands of the employee as per section 10(10CC). Further, as per section 40(a)(v) the tax paid by the employer on non-monetary perquisites provided to employees shall not be deductible in computing profits and gains from business or profession. The tax auditor is required to report the amount of such tax paid by the employer, in case it is debited to the profit and loss account under clause 21(b)(viii).

31.18 In case where the assessee submits that any sum debited to profit and loss account is not inadmissible under the provisions of sub-section (a) of section 40, the tax auditor may exercise his judgement in the light of the applicable laws and report accordingly about the compliance of this provision. The tax auditor may rely upon the judicial pronouncements while taking any particular view. In case of difference of opinion between the tax auditor and the

assessee, the tax auditor should state both the view points. In case of voluminous nature of the information, the tax auditor can apply materiality principles, tests checks and compliance tests for verifying the information required to be provided under this clause.

32. Clause 21(c)- Amount debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;

32.1 The tax auditor is required to state the inadmissible amount under section 40(b)/40(ba) and such information is also required to be given in respect of interest/ remuneration paid to a member of an Association of persons (AOP)/Body of individuals (BOI). By Finance Act (No.2) 2009, w.e.f. 1.4.2010, the term firm includes LLP (as registered under the provisions of LLP Act, 2008) The word "inadmissible" implies that the tax auditor will have to examine the facts, apply the conditions for allowance or disallowance and accordingly determine the prima facie inadmissibility of the deduction and also quantify the same.

32.2 Salary, bonus, commission or remuneration or interest are not admissible, unless the following conditions are satisfied:

- (a) Remuneration is paid to working partner(s).
- (b) Remuneration or interest is authorised by the partnership deed and is in accordance with the partnership deed.
- (c) Remuneration or interest does not pertain to a period prior to the date of partnership deed.

32.3 The inadmissible remuneration, salary, bonus or commission under section 40(b) has to be determined on the basis of the provisions of sub-clause (v) thereof read with the limits laid down therein. Such limits are laid down as a percentage of book profits. Explanation 3 to section 40(b) provides that "book profits" means the net profit, as shown in the profit and loss account for the relevant previous year, computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit. The inadmissible amount of salary, bonus, commission or remuneration is to be worked out after deducting interest allowable to partners as per the provisions of section 40(b). According to Explanation 4, "working partner" means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner. It is advisable for the auditor to obtain from the assessee a detailed working of the inadmissible remuneration, salary, bonus or commission under section 40(b). He has to verify the computation from the instrument or agreement or any other document evidencing partnership including any supplementary documents or other documents effecting changes which would affect the computation of the inadmissible amounts under section 40(b).

32.4 Under section 40(b)(iv), any payment of interest to any partner which is authorised by, and is in accordance with, the terms of the partnership deed and relates to any period falling

III.282 Auditing Pronouncements

after the date of such partnership deed in so far as such amount exceeds the amount calculated at the rate specified under the Income-tax Act from time to time will not be admissible as a deduction.

32.5 Section 40(ba) lays down that any interest or remuneration paid by an AOP to its member shall not be allowed as a deduction to the AOP. It may also be noted that in computing such disallowance:

- (a) where interest is paid by AOP / BOI to a member who has also paid interest to AOP/ BOI, only net amount of interest, if any, shall be disallowed;
- (b) where a member is in a representative capacity, the disallowance of net interest paid by AOP/BOI shall be the amount of net interest received by the member in a representative capacity or by the person who is so represented by the member;
- (c) where a person who is a member in his individual capacity receives the interest for the benefit of or on behalf of any other person, then, interest so paid by AOP/ BOI shall not be disallowed;

32.6 In order to determine the amounts inadmissible under section 40(b), the tax auditor should obtain the computation of total income from the assessee.

32.7 In working out the inadmissible amount the tax auditor must have due regard to the Circular No.739 dated 25.3.1996 issued by the Board reproduced in **Appendix XI (Page no. 269)**.

32.8 The tax auditor should maintain the information in the following format as a part of his working papers and report appropriately in the format provided in the e-filing utility:

Sr. No.	Nature of payments made to partner/member	Section 40(b)/40 (ba)	Amount debited to profit and loss account	Amount admissible u/s 40(b)/ 40(ba)	Amount inadmissible u/s 40(b)/ 40(ba) [difference between (c) and (d)]	Remarks, if any
(a)	(b)	(c)	(d)	(e)	(f)	(g)

32.9 The tax auditor may note that the information required to be reported is the amount of inadmissible expenditure as per section 40(b) or 40(ba) and not the total amount debited to profit and loss account.

33. Clause 21(d) – Disallowance/deemed income under section 40A(3):

(A) On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:

Serial Number	Date of Payment	Nature of Payment	Amount	Name and Permanent Account Number of the payee, if available

(B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);

Serial Number	Date of Payment	Nature of Payment	Amount	Name and Permanent Account Number of the payee, if available

[Clause 21(d)]

33.1 (a) As per the provisions of the sub-section (3) of section 40A where the assessee incurs any expenditure in respect of a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, exceeding rupees twenty thousand, no deduction would be allowed in respect of such expenditure. In case of payment made for plying, hiring or leasing of goods carriage, limit is Rs.35,000/- instead of Rs.20,000/-.

(b) Further, as per the provisions of section 40A(3A) where any allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during the previous year the assessee makes payment in respect thereof, otherwise than an account payee cheque drawn on a bank or account payee bank draft exceeding Rs.20,000, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income tax with respect to that previous year. In case of payment made for plying, hiring or leasing of goods carriage, limit is Rs.35,000/- instead of Rs.20,000/-.

(c) Further, no disallowance would be made if the payment or aggregate of payments, exceeding Rs. 20,000 (Rs. 35000 in case of plying, hiring or leasing of goods carriage) is made to a person in a day otherwise than by an account payee cheque drawn on a bank or account payee bank draft in respect of cases and circumstances prescribed under Rule 6DD having regard to the nature and extent of banking facilities available, considerations of business expediency and other relevant factors. Notification No.97/2008 dated 10.10.2008 has amended Rule 6DD w.e.f. A.Y. 2008-09

III.284 Auditing Pronouncements

33.2 For the purpose of furnishing the above particulars, the tax auditor should obtain a list of all cash payments in respect of expenditure exceeding Rs.20,000 (Rs.35000/- in case of plying, hiring or leasing goods carriages w.e.f. 1.10.2009) made by the assessee during the relevant year which should include the list of payments exempted in terms of Rule 6DD with reasons. This list should be verified by the tax auditor with the books of account in order to ascertain whether the conditions for specific exemption granted under clauses (a) to (l) of Rule 6DD are satisfied. Details of payments which do not satisfy the above conditions should be stated under this clause.

33.3 The tax auditor has to take into account the technological advancements in the field of banking and information technology where payments have been taken other than through an account payee cheque or bank draft. Rule 6DD of the Rule specifically exempts the cases where the payment is made by any letter of credit arrangements through a bank; a mail or telegraphic transfer through a bank; a book adjustment from any account in a bank to any other account in that or any other bank; a bill of exchange made payable only to a bank; the use of electronic clearing system through a bank account; a credit card; a debit card. 33.4 Practically, it may not be possible to verify each payment, reflected in the bank statement, as to whether the payment has been made through account payee cheque, demand draft, pay order or not, it is thus desirable that the tax auditor should obtain suitable certificate from the assessee to the effect that the payments for expenditure referred to in section 40A(3) and section 40A(3A) were made by account payee cheque drawn on a bank or account payee bank draft, as the case may be. Where the reporting has been done on the basis of the certificate of the assessee, the fact shall be reported as an observation in clause (3) of Form No. 3CA and clause (5) of Form No.3CB, as the case may be.

33.4 The tax auditor should maintain the following particulars in his audit working papers file for the purpose of reporting in the format provided in the e-filing utility:

Sl. No.	Nature and particulars of expenditure	Date of payment	Payment or aggregate payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft	Total amount of expenditure	Name and Permanent Account number of the payee, if available	Remarks
1	2	3	4	5	6	7

33.5 Wherever possible individual items of inadmissible expenses may be given. However, where, in view of the large volume of transactions it is not possible to give individual items of inadmissible amounts, the tax auditor may furnish such details under broad heads of accounts.

33.6 Items of expenditure in respect of which specific exemption has been given under Clauses (a) to (l) of Rule 6DD are not required to be stated under this clause.

34. Clause 21(e) - provision for payment of gratuity not allowable under section 40A(7);

34.1 As per section 40A(7), the deduction shall be allowed in relation to any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year.

34.2 The tax auditor should call for the order of the Commissioner of Income-tax granting approval to the gratuity fund, verify the date from which it is effective and also verify whether the provision has been made as provided in the trust deed.

34.3 In case the provision made for payment of gratuity is not allowable under section 40A(7), the same is to be stated under this sub-clause.

35. Clause 21(f) - any sum paid by the assessee as an employer not allowable under section 40A(9);

35.1 Under section 40A(9) any payment made by an employer towards the setting up or formation of or as contribution to any fund, trust, company, association of persons, body of individuals, society registered under the Societies Registration Act, 1860, or other institutions (other than contributions to recognised provident fund or approved superannuation fund or notified pension scheme or approved gratuity fund) is not allowable. The tax auditor should furnish the details of payments which are not allowable under this section.

35.2 It may be noted that section 40A(9) allows deduction of any contributions made as an employer towards recognized provident fund or approved superannuation fund or notified pension scheme or approved gratuity fund or as required by or under any other law for the time being in force. Thus, any contribution made to Employees' Welfare Co-op Society will not be allowed as a deduction in the case of the employer company under section 40A(9), unless such contribution is required by or under any other law for the time being in force. *Instruction: No. 1799, dated 3-10-1988.*

36. Clause 21(g) - particulars of any liability of a contingent nature:

36.1 The assessee is required to furnish particulars of any liability of a contingent nature debited to the profit and loss account. The tax auditor may not be able to immediately ascertain the details of contingent liabilities debited to the profit and loss account without a detailed scrutiny of various account heads e.g. outstanding liabilities, provision etc.

III.286 Auditing Pronouncements

Accounting policy followed and disclosed would be helpful in ascertaining and verifying details. The expenses relating to disputed claims will be revealed only on the basis of the scrutiny of records relating to contingent liabilities. The tax auditor may look into particular items of contingent liabilities of the earlier year in order to determine whether or not any items has been charged to the profit and loss account of the current year and if so, whether the liability continues to be contingent in nature. Wherever necessary, a suitable note should be given by the tax auditor as to the non-availability of such particulars relating to the contingent liabilities.

36.2 Reference may be made to AS-29, 'Provisions, Contingent Liabilities and Contingent Assets' to determine what should normally be treated as a contingent liability.

36.3 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility

Nature of liability	Amount
1	2

37. Clause 21(h) - Amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;

37.1 Section 14A was inserted in Chapter IV – Computation of total income by the Finance Act, 2001 with retrospective effect from 1.4.1962 i.e. A.Y. 1962-63. Accordingly, for the purposes of computing the total income under Chapter IV of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The Finance Act, 2002 added a proviso to section 14A to the effect that nothing contained in the section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the first day of April, 2001.

37.2 As per sub-section (2), the Assessing Officer shall determine the amount of expenditure incurred in relation to such income, which does not form part of the total income under the Act. Such determination should be in accordance with the method as may be prescribed. Such power of the Assessing Officer can be exercised only when he, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee.

37.3 Sub-section (3) provides that the provisions of subsection (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act.

37.4 The expenditure which is relatable to the income which does not form part of the total income is not allowed as a deduction in terms of section 14A of the Act. Such income are dealt with in Part III- Incomes Which Do Not Form Part Of Total Income. Section 10 deals with

Incomes not included in total income. Sections 10A to 10C deals with the special provisions in respect of the specified undertakings. In general, an assessee may have besides his business income, income from agriculture which is exempt under sub-section (1), share of profit in a partnership firm which is exempt under sub-section (2A), income from dividends referred to in section 115-O which is exempt under sub-section (34), long term capital gains on the transfer of equity shares which is exempt under sub-section (38) etc. In all such cases, the expenditure relating to the income which is not included in total income is inadmissible under section 14A. In case of an investment in a partnership firm, while the interest and the salary received by the partner are taxable, the share of profit is exempt. The amount of inadmissible expenditure depends on the facts and circumstances of each case.

37.5 The Central Board of Direct Taxes, had through Income-tax (Fifth Amendment) Rules, 2008 inserted a new Rule 8D which lays down the method for determining the amount of expenditure in relation to income not includible in total income. Sub-rule (1) of Rule 8D provides that having regard to the accounts of the assessee of a previous year, if the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of such inadmissible expenditure in accordance with the method of computation laid down in sub-rule (2) of Rule 8D.

37.6 Sub-rule (2) of Rule 8D provides for the method of computation of the expenditure in relation to income not forming part of the total income. The disallowance shall be the aggregate of the following:

- (i) the amount of expenditure directly relating to income which does not form part of total income;
- (ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely :

$$A \times \frac{B}{C}$$

Where A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

III.288 Auditing Pronouncements

- (iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

“Total Assets” for the purpose of Rule 8D shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

37.7 The method prescribed under sub-rule (2) of Rule 8D is applicable when the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred. Normally this situation would arise at the time of assessment i.e. after the tax audit has been completed and the return has been filed. Therefore, at the time of tax audit the tax auditor will have to verify the amount of inadmissible expenditure as determined by the assessee. The method under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the amount as determined by the assessee. Rule 8D does not mandate that the assessee should necessarily compute the disallowance as per the method prescribed under sub rule (2). Therefore, the assessee may or may not adopt the same.

37.8 It is primarily the responsibility of the assessee to furnish the details of amount of deduction inadmissible in terms of section 14A i.e. in respect of the expenditure incurred in relation to income, which does not form part of the total income. The tax auditor shall examine the details of amount of inadmissible expenditure as furnished by the assessee. While carrying out such examination the tax auditor is entitled to rely on the management representation. However, Standard on Auditing (SA) 580, *Written representations* may be referred to.

37.9 The tax auditor will verify the amount of inadmissible expenditure as estimated by the assessee with reference to established principles of allocation of expenditure based on logical parameters like proportion of exempt and taxable income recorded, turnover, man hours spent to earn the relevant income etc. For allocation of interest between taxable and non-taxable income, the quantum of investment, the period and the rate of interest are generally the relevant factors to be considered. This requires proper estimates to be made by the assessee. The tax auditor is required to audit such estimates. Attention is invited to Standard on Auditing - 540 “Audit of Accounting Estimates”.

37.10 An assessee may claim that no expenditure has been incurred by him in relation to income which does not form part of the total income under the Act. Even in such a case the provisions of section 14A will apply. Accordingly, the tax auditor is required to verify such contention of the assessee.

37.11 As stated before the method prescribed under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the correctness of claim made by the assessee. As per clause (i) of sub-rule (2) the expenditure which is directly relatable to income which does not form part of total income is inadmissible expenditure. Besides such

expenditure there may be expenditure such as interest, which is relatable to both taxable and non-taxable income which needs to be properly allocated while calculating the inadmissible amount. Interest which, can be directly attributable to any particular income or receipt chargeable to tax needs to be excluded while determining the inadmissible amount. Clause (ii) of sub-rule (2) of rule 8D deals with allocation of interest which, is not directly attributable to any particular income or receipt. However the variable A used in the formula in clause (ii) of sub- rule (2) is said to be equal to the amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year. It may be seen that what is proposed to be allocated as per clause (ii) is interest which is not directly attributable to any particular income or receipt. Therefore, variable A is the amount of expenditure by way of interest other than the amount of interest directly attributable to any non taxable income as per clause (i) and also interest which may be directly attributable to any taxable income. Interest on term loan may be an example of such interest which is generally related to taxable income and is therefore excluded.

37.12 The broad principles enunciated in para 16.3 may be kept in mind while verifying the amount of inadmissible expenditure. After verifying the amount of inadmissible expenditure, if the tax auditor:

- (a) is in agreement with the assessee, he should report the amount with suitable disclosures of material assumptions, if any.
- (b) is not in agreement with the assessee with regard to the amount of expenditure determined, he may give:

- A qualified opinion:

A qualified opinion can be given when the auditor is of the opinion that the effect of any disagreement with the assessee is not so material and pervasive as to require an adverse opinion or limitation on scope is not so material and pervasive as to require a disclaimer of opinion.

- An adverse opinion:

The auditor in rare circumstances may come across a situation where the impact of his disagreement about the computation of such inadmissible expenditure is so material and pervasive that it affects the overall opinion. In such a case the tax auditor may give an adverse opinion.

-The disclaimer of opinion:

When the assessee has neither provided the basis nor the supporting documents, for the claim of such inadmissible expenditure, then due to limitation on the scope of auditors work, the auditor can give disclaimer of opinion.

38. Clause 21(i)- amount inadmissible under the proviso to section 36(1)(iii).

III.290 Auditing Pronouncements

38.1 The provisions of section 36(1)(iii) provide that the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession would be allowed as a deduction in computing the income referred to in section 28 of the Act.

38.2 The proviso thereunder (inserted by the Finance Act, 2003 w.e.f. A.Y. 2004-05) provides that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books or account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was put to use, shall not be allowed as a deduction.

38.3 The extension of an existing business or profession is a fact based exercise and the tax auditor should apply the professional judgment in determining the applicability of the proviso. The tax auditor is also advised to verify the treatment given for such asset under other provision of the Act like Chapter VI A deductions or under other statutes.

38.4 The requirements of sub-clause (i) are applicable in respect of capital borrowed for acquisition of an asset for extension of the existing business or profession. The assessee has to furnish the details of amount inadmissible under the proviso to section 36(1)(iii). The tax auditor has to verify the correctness of the particulars furnished by the assessee with the documentary evidence.

38.5 The Tax Auditor while determining the admissible/inadmissible amount under section 36(1)(iii) should also keep in mind the requirements of Accounting Standards 16 of Indian GAAP – “Borrowing Cost”.

38.6 The Explanation provides that recurring subscription paid periodically by shareholders or subscribers in Mutual Benefit Society which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of section 36(1)(iii).

38.7 The Explanation becomes applicable only where the computation of the income of such mutual benefit society is to be made under section 28 read with section 44A.

39. Clause 22- Amount inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006

[Clause (22)]

39.1 This clause was inserted by the Central Board of Direct Taxes through its Notification No. 36/2009 dated 13-4-2009, in the Form No.3CD in Appendix II of the Income-tax Rules, 1962.

39.2 The tax auditor is required to state the amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. The Micro, Small and Medium Enterprises Development Act, 2006 (MSME Act) is an Act to provide for facilitating the promotion and development and enhancing the competitiveness of micro, small and medium enterprises and for matters connected therewith or incidental thereto.

39.3 Section 23 of the MSME Act lays down that an interest payable or paid by the buyer, under or in accordance with the provisions of this Act, shall not for the purposes of the computation of income under the Income-tax Act, 1961 be allowed as a deduction.

39.4 The inadmissible interest has to be determined on the basis of the provisions of the MSME Act. Section 16 of the MSME Act provides for the date from which and the rate at which the interest is payable. Accordingly, where a buyer fails to make payment of the amount to the supplier, as required under section 15, the buyer shall, notwithstanding anything contained in any agreement between the buyer and the supplier or any law for the time being in force, be liable to pay compound interest with monthly rests to the supplier on that amount from the appointed date or, as the case may be, from the date immediately following the date agreed upon, at three times of the bank rate notified by the Reserve Bank.

39.5 Section 15 of the MSME Act, requires the buyer to make payment on or before the date agreed upon in writing, or where there is no agreement in this behalf, before the appointed day. It also provides that the period agreed upon in writing shall not exceed forty five days from the day of acceptance or the day of deemed acceptance.

39.6 Section 22 of the MSME Act provides that where any buyer is required to get his annual accounts audited under any law for the time being in force, such buyer shall furnish the following additional information in his annual statement of accounts, namely:-

- (i) The principal amount and interest due thereon (to be shown separately) remaining unpaid to any supplier as at the end of each accounting year;
- (ii) The amount of interest paid by the buyer in terms of Section 16, along with the amount of payment made to supplier beyond the appointed date during each accounting year;
- (iii) The amount of interest due and payable for the delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under this Act;
- (iv) The amount of interest accrued and remaining unpaid at the end of each accounting year; and
- (v) The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues as above are actually paid to the small enterprise, for the purpose of disallowance as a deductible expenditure under section 23.

39.7 Where the tax auditor is issuing his report in Form No.3CB, he should verify that the financial statements audited by him contain the information as prescribed under section 22 of the MSME Act. If no disclosure is made by the auditee in the financial statements he should give an appropriate qualification in Form No.3CB, in addition to the reporting requirement in clause 22 of Form No. 3CD.

39.8 The tax auditor while reporting in respect of clause 22 should take the following steps:

III.292 Auditing Pronouncements

- (a) The auditor should seek information regarding status of the enterprise i.e. whether the same is covered under the Micro, Small and Medium Enterprises Development Act, 2006. Where the information is available and has been disclosed the same should be reported as such in Form No. 3CD. Where the information is not available the auditor should also mention the same in the Form No.3CD.
- (b) Since Section 22 of the Micro, Small and Medium Enterprises Development Act, 2006 requires disclosure of information, the tax auditor should cross check the disclosure made in the financial statements.
- (c) Obtain a full list of suppliers of the assessee which fall within the purview of the definition of "Supplier" under section 2(n) of the Micro, Small and Medium Enterprises Development Act, 2006. It is the responsibility of the auditee to classify and identify those suppliers who are covered by this Act.
- (d) Review the list so obtained.
- (e) Verify from the books of account whether any interest payable or paid to the buyer in terms of section 16 of the MSME Act has been debited or provided for in the books of account.
- (f) Verify the interest payable or paid as mentioned above on test check basis.
- (g) Verify the additional information provided by the auditee relating to interest under section 16 in his financial statement.
- (h) If on test check basis, the auditor is satisfied, then the amount so debited to the profit and loss account should be reported under clause 22.

39.9 Where the tax auditor, upon due verification, finds that the auditee has neither provided for nor paid any interest payable under the MSME Act, the no amount is inadmissible under section 23 of MSME Act. In such a case, appropriate reporting should be made against this clause in the format provided in the e-filing utility.

39.10 A question may come up, as to what would be disallowance, in case the auditee is liable to pay any interest under MSME Act, but he has not provided the interest in his accounts. In such a case, there can be no disallowance, as he has not claimed the same in his accounts. But whenever he pays and claim such interest, the same will be disallowable in year of payment. In case the auditee has adopted mercantile system of accounting, the non-provision may affect true and fair view and the auditor should give suitable qualification.

39.11 The relevant extracts of the MSME Act are given in **Appendix XII (Page no 271)**.

40. Particulars of payments made to persons specified under section 40A(2)(b). [Clause 23]

40.1 Section 40(A)(2) provides that expenditure for which payment has been or is to be made to certain specified persons listed in the section- Refer **Appendix XIII (Page no. 273)** may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or

unreasonable having regard to:

- (i) the fair market value of the goods, services or facilities for which the payment is made; or
- (ii) for the legitimate needs of business or profession of the assessee; or
- (iii) the benefit derived by or accruing to the assessee from such expenditure.

Further, proviso to section 40A(2)(a) provides that no disallowance on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.

40.2 The section enjoins on the Assessing Officer the power to fix the quantum of disallowance. Under this clause, the particulars of payments coming under this sub-section are to be stated. The following steps may be taken by the tax auditor in this connection:

- (a) Obtain full list of specified persons as contemplated in this section.
- (b) Obtain details of expenditure/payments made to the specified persons.
- (c) Scrutinise all items of expenditure/payments to the above persons.
- (d) It may be difficult to locate all such payments and it may also involve a time consuming effort. It is, however, possible to localise the area of enquiry by ascertaining the following:
 - (i) Call for all contracts or agreements entered into by the assessee and list out the contracts or agreements entered into with the specified persons and segregate the items of payments made to them under these agreements.
 - (ii) In case of payments for purchases and expenses on credit basis, the appropriate ledger accounts can be scrutinised to identify the dealings with the specified persons.
 - (iii) In case of cash purchases and expenses, the purchase or expense account should be scrutinised. It may be difficult to identify such payments in each and every case where the volume of transactions is rather huge and voluminous. Therefore, it may be necessary to restrict the scrutiny only to such payments in excess of certain monetary limits depending upon the size of the concern and the volume of business of the assessee.
 - (iv) In case of a large company, it may not be possible to verify the list of all persons covered by this section and, therefore, the information supplied by the assessee can be relied upon. In this context, a reference may be made to Circular No.143 dated 20.8.1974, issued by the Board, in which it is clarified that a tax auditor can rely upon the list of persons covered under Section 13(3) as given by the managing trustee of a Public Trust. (Refer Appendix 'B' of "A Guide to Audit of Public Trusts under the Income-tax Act" published by the Institute). Where the

III.294 Auditing Pronouncements

tax auditor relies upon the information in this regard furnished to him by the assessee it would be advisable to make an appropriate disclosure.

40.3 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility: :

Name of the related party	PAN of related person	Relation	Date	Payment made (Amount)
1	2	3	4	5

40.4 The Finance Act, 2012 had amended Section 40A(2)(a) to provide that the transactions referred to in Section 92BA (called Specified Domestic Transactions) with persons referred to in 40A(2)(b) shall be at Arm's Length Price. The tax auditor is advised to refer the "Guidance Note on Report under section 92E of the Income tax Act, 1961" issued by ICAI for compliance of these provisions.

41. Amounts deemed to be profits and gains under section 32AC, 33AB or 33ABA or 33AC.

[Clause 24]

41.1 Section 32AC allows deduction @ 15% in respect of Investment in new Plant & Machinery to a company who is engaged in the business of manufacture or production of any article or thing and who acquires and installs new asset after the 31st day of March,2013 but before the 1st day of April,2015 and the aggregate actual cost of such new assets exceeds one hundred crore rupees. The Finance Act, 2014 has amended section 32AC w.e.f. financial year 2014-15. The investment limit in the plant and machinery has been reduced to Rs. 25 crores from Rs. 100 crores. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections (2) of section 32AC. Only because section 32AC(2) provides for chargeability of deemed income under the head "profit and gains from business or profession" in addition to taxability of capital gains, the auditor is not required to report any capital gains/losses arising on transfer on the said asset. The tax auditor will be required to verify the compliance to the conditions of the provisions of section 32AC and report the claim of deduction accordingly.

41.2 Section 33AB allows deduction in respect of Tea Development Account, Coffee Development Account and Rubber Development Account. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections [4], [5], [7] and [8] of section 33AB.

41.3 Section 33ABA allows deduction in respect of Site Restoration Fund. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections [5], [7] and [8] of section 33ABA. Where deduction has been claimed with respect to interest credited in Special Account or the Site Restoration

Account, utilization of withdrawal thereof for purposes other than those specified shall be deemed to be income from business.

41.4 Likewise, section 33AC allows deduction in respect of reserve created out of the profit of the assessee engaged in shipping business to be utilized in accordance with the provision of sub section (2) of section 33AC. The tax auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub-sections (3) and (4) of section 33AC for the amount of reserves created on or before 31st March, 2004. However, consequent to the amendment made by the Finance (No.2) Act, 2004, no deduction shall be allowed under section 33AC for any assessment year commencing on or after 1st day of April, 2005.

41.5 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

Section	Description	Amount
1	2	3

42. Any amount of profit chargeable to tax under section 41 and computation thereof.
[Clause 25]

42.1 (i) Section 41(1) provides that where any allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee and subsequently during any previous year the assessee obtains any amount, whether in cash or in any other manner whatsoever, in respect of such loss or expenditure or some benefits in respect of trading liability by way of remission or cessation thereof, the amount obtained by him or the value of benefit accruing to him is chargeable to tax as business income.

(ii) Where the assessee who has suffered loss or has incurred expenditure for which deduction has been allowed or by whom the trading liability has been incurred is succeeded in his business either because of amalgamation of companies or demerger or on account of the constitution of new firm or the business if continued by some other person when the assessee ceases to carry on the business, then the successor in the business will be chargeable to tax on any amount received in respect of such loss, expenditure or trading liability.

(iii) *Explanation* (1) to section 41(1) provides that the expression "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cession thereof" shall include the remission or cession of any liability by a unilateral act of the assessee or successor in the business by way of writing off such liability in his accounts.

(iv) Liability of assessee does not cease merely because liability has become barred by limitation. Liability ceases when it has become barred by limitation and the assessee has unequivocally expressed its intention not to honour the liability, when demanded. This is a question of fact whether or not assessee has expressed unequivocally his intentions {CIT Vs

III.296 Auditing Pronouncements

Chase Bright Steel Ltd 177 ITR 128 (BOM)}. When a liability is shown outstanding for more than 4 years, in case of an assessee company, this amounted to acknowledging the debt in favour of creditors for the purposes of section 18 of the Limitation Act, 1963. The assessee's liability to the creditors thus subsisted and did not cease nor was it remitted by the creditors. The liability was enforceable in the court of Law. The amount was not assessable under section 41(1). This was so held by Delhi High Court in the case of *CIT V/s Shri Vardhman Overseas Ltd(2012) 343 ITR 408(Del)*. [SLP has been dismissed by the Supreme Court against this decision.]

42.2 Section 41(2) provides for chargeability to income-tax as income of the business of the previous year in which the moneys payable for the building, machinery, plant or furniture of an undertaking engaged in generation or generation and distribution of power is sold, discarded, demolished or destroyed. Such undertakings are allowed depreciation on such percentage on the actual cost as are prescribed. The depreciation rate are prescribed vide Rule 5(IA) in Appendix IA. Depreciation is to be calculated on Straight Line Method (SLM) on individual asset and not on block of assets, under clause (i) of sub-section (1) of section 32. Where the moneys payable in respect of such building, machinery, plant or furniture, as the case may be, together with the amount of scrap value, if any, exceeds the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down value shall be chargeable to income-tax as income of the business of the previous year in which the moneys payable for the building, machinery, plant or furniture become due. Where the moneys payable in respect of the building, machinery, plant or furniture become due in a previous year in which the business, for the purpose of which the building, machinery, plant or furniture was being used, is no longer in existence, the above provision shall apply as if the business is in existence in that previous year. To ascertain capital gain, if any, provisions of section 50A are relevant.

42.3 Section 41(3) provides that where any capital asset used in scientific research is sold without having been used for other purposes and the sale proceeds together with the amount of deduction allowed under section 35 exceeds the amount of capital expenditure, such surplus or the amount of deduction allowed, whichever is less, is chargeable to tax as business income in the year in which the sale took place. This is irrespective of whether the business of the assessee is in existence or not during the previous year in which the capital asset is sold.

42.4 It may be noted that section 41(3) is applicable only if an asset is sold without having been used for other purposes. In other words, if an asset which is initially purchased for the purpose of scientific research is utilised for business purposes on completion of scientific research and later on is sold or transferred, then section 41(3) is not applicable but in such case section 50 would apply.

42.5 Section 41(4) provides where any bad debt has been allowed as deduction under section 36(1) (vii) and the amount subsequently recovered on such debt is greater than the

difference between the debt and the deduction so allowed, the excess realisation is chargeable to tax as business income of the year in which debt is recovered. For this purpose, it is immaterial whether the business of the assessee is in existence or not during the previous year in which recovery is made.

42.6 Section 41(4A) provides that if any amount is withdrawn from the special reserve created under section 36(1)(viii), then it will be chargeable to tax in the year in which the amount is withdrawn, regardless of the fact whether the business is in existence in that year or not.

42.7 Section 41(5) provides that where the business or profession referred to in section 41 is no longer in existence and there is income chargeable to tax under sub-section (1), sub-section (3), sub-section (4) or sub-section (4A) in respect of that business or profession, any loss, not being a loss sustained in speculation business which arose in that business or profession during the previous year in which it ceased to exist and which could not be set off against any other income of that previous year shall, so far as may be, be set off against the income chargeable to tax under the sub-sections aforesaid. This is irrespective of the number of years that may have elapsed from the year in which the loss has been suffered.

42.8 The tax auditor should obtain a list containing all the amounts chargeable under section 41 with the accompanying evidence, correspondence, etc. He should in all relevant cases examine the past records to satisfy himself about the correctness of the information provided by the assessee. The tax auditor has to state the profit chargeable to tax under this section. This information has to be given irrespective of the fact whether the relevant amount has been credited to the profit and loss account or not. The computation of the profit chargeable under this clause is also to be stated.

42.9 The tax auditor should maintain the following in his working papers for the purpose of furnishing details required in the format provided in the e-filing utility:

Sr. No.	Name of person	Amount of income	Section	Description of transaction	Computation if any
1	2	3	4	5	6

43. In respect of any sum referred to in clause (a), (b), (c), (d), (e) or (f) of section 43B, the liability for which:-

- (A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was
 - (a) paid during the previous year;
 - (b) not paid during the previous year;
- (B) was incurred in the previous year and was
 - (a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);

(b) not paid on or before the aforesaid date.

(State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost etc. is passed through the profit and loss account.)

[Clause 26]

43.1 In the case of an assessee maintaining its accounts on the mercantile system, the tax auditor should verify the aforesaid particulars of section 43B from the books of account for the year under audit as well as from the books of account, vouchers and documents of the immediately succeeding assessment year as well as return of income for the earlier assessment years so that the information about the aforesaid payments made in the subsequent year can be furnished.

43.2 Section 43B provides that notwithstanding anything contained in any other provisions of the Act, the following amounts shall be allowed as deduction in computing the business income of an assessee in the previous year in which such amounts are actually paid:

- (a) any tax, duty (sales tax, value added tax, service tax, excise duty, municipal/property tax, etc.), cess or fee, by whatever name called, payable by the assessee under any law for the time being in force.
- (b) any sum payable as an employer by way of contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees.
- (c) any bonus or commission payable by the assessee to its employees for services rendered, where such sum would not have been payable to him as profits or dividend, if it had not been paid as bonus or commission.
- (d) interest on any loan or borrowing from any public financial institution, a state financial corporation or a state industrial investment corporation payable in accordance with the terms and conditions of the agreement governing such loan or borrowing.
- (e) any sum payable by the assessee as interest on any loan or advances from a scheduled bank in accordance with the terms and conditions of the agreement governing such loan or advances.
- (f) any sum payable by the assessee as an employer in lieu of any leave at the credit of his employee.

43.3 All the payments referred in clause (a) to (f) above whether pre-existed on the first day of previous year but not allowed in assessment of any preceding previous years or incurred in the previous year are to be reckoned. In respect of the liability which pre-existed on the first day of the previous year is allowable as deduction if paid during the previous year. This is required to be reported in clause 26(A)(a). In respect of the liability which is incurred in the previous year is allowable to the extent it is paid on or before the due date for furnishing the return of the income under section 139(1). Such items are to be disclosed in clause 26(B)(a).

43.4 The tax auditor, in his tax audit report, should, therefore, clearly distinguish the liability incurred during the previous year in respect of all the specified sums referred to in clauses (a) to (f) from the liability that pre-existed on the first day of the relevant previous year.

43.5 If the assessee is following the cash basis of accounting, sums referred to in clause (a), (b), (c), (d), (e) and (f) of section 43B which are debited to the profit and loss account will be allowable as they would have been actually paid during the year.

43.6 Under the first proviso to section 43B, deduction is available in respect of any sum which is actually paid by the assessee on or before the due date applicable in his case for furnishing the return of income under sub-section (1) of section 139. Since the due date of filing of the return would usually be subsequent to the signing of the tax audit report the tax auditor would be able to give information in respect of matters only upto the date of signing of the tax audit report. The payment made subsequent to that date but before the date of filing of the return, will still be eligible for deduction under section 43B. Where due date for filing of return of income is extended, payments made upto the extended due date also qualify for deduction.

43.7 The provision made in the accounts for excise duty payable on finished goods in the bonded warehouse will also have to be disclosed under this clause. For enabling the assessee to claim this amount as a deduction the tax auditor may have to verify that the said goods have been cleared and that excise duty thereon has been paid or adjusted against CENVAT credits before the due date applicable in his case for furnishing the return of income under section 139 (1).

43.8 Under section 43B(a), sales-tax when paid is allowed as a deduction. Although under clause (a) of section 43B items that have been debited to the profit and loss account but not paid during the previous year, are to be specified, where it is the practice of the company to maintain a separate sales-tax/service tax/excise duty account and treat the sales tax/excise duty collected as a liability, it would be necessary to show by way of note under this clause, the amount of sales tax/excise duty collected but not paid. In case, any sum has been paid before the due date of filing the return, the date and the amount of payment along with the amount paid should also be disclosed.

43.9 There are different legal decisions with respect to allowability of employees contribution towards PF, EPF, etc not paid within due date. Bombay High Court in the case *CIT vs Pamwi Tissues Ltd (2008)215 CTR (Bom)150* and Gujarat High Court in the case of *CIT vs. Gujarat State Road Transport Corp. (2014) 223 taxmann 398 (Guj.)* held that employees contribution not paid within the due dates prescribed in Explanation to section 36(1)(va) was disallowable under section 43B. On the other hand Delhi High Court in the following cases has held in the favour of assesseees.

CIT vs Dharmendra Sharma 297 ITR 320

CIT vs P.M. Electronics Ltd 313 ITR 161

III.300 Auditing Pronouncements

CIT vs AIMIL Ltd and others 321 ITR 508

43.10 It may be noted that emoluments in the nature of good work reward, incentives or ex-gratia are not bonus or commission as contemplated under section 36(1)(ii) but are deductible under section 37 of the Act as held by *Delhi High Court in Shri Ram Pistons and Rings Ltd. 307 ITR 363 and Autopins (India) Ltd. 192ITR161.*

43.11 The Explanations 3C and 3D to section 43B clarify that a deduction of any sum being interest payable under clause (d) and clause (e) of section 43B shall be allowed, if such interest has been actually paid and any interest referred to in that clause which has been converted into a loan or advance shall not be deemed to have been actually paid. Circular No.7/2006 dated 17th July, 2006 observes that the clarificatory Explanations only reiterate the rationale that conversion of interest into a loan or borrowing or advance does not amount to "actual payment". The circular clarifies that the unpaid interest whenever actually paid to the bank or financial institution will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, the converted interest, by whatever name called, in the wake of its conversion into a loan or borrowing or advance, will be eligible for deduction in the computation of income of the previous year in which the converted interest is 'actually paid'. In other words, nomenclature of the sum of converted interest will make no difference as the sum of converted interest whenever is actually paid will not represent repayment of the principal. The circular clarifies that the fundamental principle remains that once an amount has been determined as interest payable to the banks or financial institutions, any subsequent change of nomenclature of interest will not affect its allowability and deduction in terms of section 43B will have to be allowed on its actual payment. The Assessing Officer would therefore be justified in seeking a certificate from the assessee to be obtained by the assessee from the lender bank or financial institution etc. as evidence of "actual payment" of interest to banks or financial institutions.

43.12 As per clause (f) sum payable by the assessee as an employer in lieu of any leave at the credit of his employees will be disallowed if not paid before the due date of filling of the return under section 139 (1).

43.13 The above particulars are required to be given irrespective of the fact whether they have been debited to profit and loss account or not and such a fact should be stated under this clause. For example, where excise, sales tax, etc. collected is accounted for as a Balance Sheet item.

43.14 In some cases the tax auditor may find amounts of the nature referred to in section 43B being credited to the profit and loss account although the relevant provisions for such liability had not been allowed as a deduction in any previous year in view of the specific provisions of section 43B requiring actual payment as a condition precedent to allowance. The amounts so credited to the profit and loss account are not chargeable to tax since the conditions referred to in section 41(1) have not been satisfied. The tax auditor should identify such items and maintain the same in his working papers.

43.15 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility;

S.No.	Section	Nature of liability	Amount
1	2	3	4

44. (a) **Amount of Central Value Added Tax credits availed of or utilized during the previous year and its treatment in the profit and loss account and treatment of outstanding Central Value Added Tax credits in the accounts.**
45. (b) **Particulars of income or expenditure of prior period credited or debited to the profit and loss account.**

[Clause 27 (a) and (b)]

44.1 Sub-clause (a) requires the factual reporting about the amount of CENVAT credits availed of or utilised during the year as well as its treatment in profit and loss account and treatment of outstanding CENVAT credits in the accounts. CENVAT credit Rules, 2002 were first introduced in place of MODVAT credit and thereafter, effective 10 September 2004, CENVAT Credit Rules, 2004 have now become applicable. CENVAT credit is available on eligible inputs, input services and capital goods. Such credits are utilized for the payment of the excise duty and service tax liability. Accordingly the tax auditor should check relevant statutory records maintained under the Central Excise Rules, 2002 and the records maintained under CENVAT Credit Rules, 2004 and ascertain therefrom the amount of credit on eligible inputs, input services and the capital goods and the amount utilised during the previous year. Records maintained in RG-23, wherever available should also be verified.

44.2. The tax auditor should verify that there is a proper reconciliation between balance of CENVAT credit in the accounts and relevant excise and service tax records. The tax auditor should report the amount of CENVAT availed and utilised under this sub-clause. In a given case CENVAT availed may be lesser than the CENVAT credit utilised during the year on account of opening balance in CENVAT account or vice-versa and as such it would be advisable, in order to avoid any misleading conclusion and inferences, to report the opening and closing balances of CENVAT. Further the sub-clause requires reporting of the credits availed of or utilized during the previous year, it is desirable to report both the credits availed and the credits utilized.

44.3 In so far as the reporting of accounting treatment of CENVAT credit is concerned the clause requires that its treatment in profit and loss account and the treatment of outstanding CENVAT credit in the account have to be reported upon.

44.4 Where the assessee follows exclusive method of accounting, the excise duty paid on purchase of raw material, capital goods and service tax paid on input services is debited to the CENVAT/ Service Tax Credit Receivable Account and not as part of the purchase cost of

III.302 Auditing Pronouncements

raw material, capital goods or cost of input services. The credit utilized is debited to the Excise Duty/ Service Tax Payable A/c and credited to CENVAT/ Service Tax Credit Receivable Account. Thus, the credit availed and utilized will not have any impact on the profit and loss account.

44.5 The reporting requirement under clause 14(b) of Form No.3CD is a requirement distinct and separate from the reporting requirement under this clause. The tax auditor should verify that information furnished under this sub-clause is compatible with the information furnished under clause 14(b).

44.6 The tax auditor should consider the above guidance while reporting in the format provided in the e-filing utility with respect of this clause.

44.7 With regard to reporting of the amount of CENVAT credits availed or utilized during the previous year and its treatment in the profit and loss account wherever possible, it is advisable to give the details of the credit availed and utilized as separate line items.

44.8 With regard to reporting of the treatment of outstanding CENVAT Credits in the account, it is desirable to mention the opening and the closing outstanding balances in the CENVAT Credits accounts as separate line items. The account in which the outstanding amount is appearing should also be mentioned appropriately..

44.9 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

CENVAT	Amount	Treatment in Profit & Loss /Accounts
Opening balance		
CENVAT Availed		
CENVAT utilized		
Closing/outstanding Balance		

45. Clause 27(b)

45.1 It may be noted that information under this clause would be relevant only in those cases where the assessee follows mercantile system of accounting. Under cash system of accounting, expenses debited/ income credited to the profit and loss account would be current year's expenses/income even though they may relate to earlier years. The tax auditor should obtain the particulars of expenditure or income of any earlier year debited or credited to the profit and loss account of the relevant previous year when mercantile system of accounting is followed. In the case of a person whose accounts of the business or profession have been audited under any other law, the information may be available from annual accounts. In the case of a person who carries on business or profession but who is not required by or under

any other law to get his accounts audited, however, a close scrutiny of the ledger in regard to the period for which expenditure or income is entered in the account books may be necessary.

45.2 It may be noted that there is a difference between expenditure of any earlier year debited to the profit and loss account and the expenditure relating to any earlier year, which has crystallised during the relevant year. Material adjustments necessitated by circumstances which though related to previous periods but determined in the current period, will not be considered as prior period items.

45.3 In such cases, though the expenditure may relate to the earlier year, it can be considered as arising during the year on the basis that the liability materialised or crystallised during the year and such cases will not be reported under this clause. Similar consideration will apply in relation to income also.

45.4 In AS - 5 as also in AS II notified by the Government under section 145, it has been explained that material charges (expenses) or credits (income) which arise in the current year as a result of errors or omissions in the accounts of the earlier years will be considered as prior period items. In view of this, the statutory auditor would normally take into consideration all items of prior period income and expenditure while giving his report on the financial statements. It would, therefore, be advisable for the tax auditor to ascertain the circumstances under which a particular expenditure has not been considered as a prior period expenditure. If, on making the enquiries he comes to the conclusion that a particular item has to be treated as prior period expenditure, he should disclose the same against this sub-clause.

45.5 The tax auditor should maintain the following information in his working papers file for the purpose of reporting in the format provided in the e-filing utility:

Sr. No.	Type	Particulars	Amount	Prior Period to which it relates (Year in yyyy-yy format)
1	2	3	4	5

46. Whether during the previous year the assessee has received any property, being share of a company not being a company in which the public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viiia), if yes, please furnish the details of the same.

[Clause 28]

46.1 Section 56(2)(viiia) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company (not being a company in which the public is substantially interested,

- (i) without consideration, the aggregate fair value of which exceeds rupees fifty thousand, the whole of the aggregate fair market value of such property

III.304 Auditing Pronouncements

- (ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration

shall be chargeable to income-tax under the head "Income from other sources"

46.2 Section 56(2)(viiia) does not apply to the property received by way of a transaction not regarded as transfer under section 47(via), 47(vic), 47(vicb), 47(vid) and 47(vii). The fair market value of shares means the value determined in accordance with the method prescribed in rule 11UA of the Income-tax Rules, 1962.

46.3 Since section 56(2)(viiia) is applicable to firms and companies in which public is not substantially interested, reporting under this clause is required only for them and not for other assessees. The auditor should obtain from the auditee, a list containing the details of shares received, if any, by him from any other company and verify the same from the books of accounts and other relevant documents. Such shares, if received will be reflected in the books of accounts either as investments or as stock in trade. In case such shares are received without consideration, the same may not be reflected in the books of accounts. Such shares may be verified from the relevant documents such as share certificates issued, if any, demat account statement etc. In either case, the same have to be reported under this clause. Attention is invited to the provisions of section 2(18) which defines the company in which public are substantially interested.

46.4 For reporting under this clause, the auditor has to consider the provisions of Rule 11UA(1)(c) which provides for manner of determining:

- (a) fair market value of quoted shares and securities received by way of transaction carried out through any recognized stock exchange
- (b) fair market value of quoted shares and securities received by way of transaction carried out OTHER THAN through any recognized stock exchange
- (c) fair market value of unquoted equity shares
- (d) fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange

46.5 Where for determining the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange, a valuation report has been obtained by the assessee from a merchant banker or an accountant, the auditor should obtain a copy of the same. Here, attention is invited to the Standard on Auditing-620 "Using the work of an Auditor's expert".

46.6 The auditor should maintain the following information in his working paper file for the purpose of reporting in the format provided in the e-filing utility:-

Sr. No.	Name of the person from whom shares have been received	PAN of the person, if available	Nature of shares (Quoted in RSE/ Quoted in URSE/ unquoted shares etc)	Name of the Company whose shares received	CIN of the company	No. of Shares Received	Fair Market value as per Rule 11UA(1)(c)	Consideration paid	Amount taxable under section 56(2)(viia) (if the difference (e)-(f) exceeds Rs.50,000)	Remarks, if any
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)

47. Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same.

[Clause 29]

47.1 Section 56(2)(viib) provides that where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head "Income from other sources".

47.2 The provisions of this clause are not applicable where the consideration is received

- (a) by a venture capital undertaking from a venture capital company or a venture capital fund
- (b) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

47.3 As per the explanation to section 56(2)(viib), the fair market value shall be the value as may be determined in accordance with such method as prescribed under Rule 11UA or as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher.

47.4 Since section 56(2)(viib) is applicable to companies in which public is not substantially interested, reporting under this clause is to be done only for corporate assesseees. The auditor should obtain from the auditee, a list containing the details of shares issued, if any, by him to any person being a resident and verify the same from the books of accounts and other relevant documents. Attention is invited to the provisions of section 2(18) which defines the company in which public are substantially interested.

III.306 Auditing Pronouncements

47.5 For reporting under this clause with respect to quoted shares, the auditor has to consider the provisions of Rule 11UA(1)(c)(a) which provides for manner of determining:

- (a) fair market value of quoted shares and securities received by way of transaction carried out through any recognized stock exchange
- (b) fair market value of quoted shares and securities received by way of transaction carried out OTHER THAN through any recognized stock exchange

47.6 For reporting under this clause with respect to unquoted equity shares, the auditor has to consider the provisions of Rule 11UA(2) which provides for manner of determining the fair market value of unquoted equity shares.

47.7 Where for determining the fair market value of unquoted equity shares, a valuation report has been obtained by the assessee from a merchant banker or an accountant, the auditor should obtain a copy of the same. Here, attention is invited to the Standard on Auditing-620 "Using the work of an Auditor's expert".

47.8 The auditor should maintain the following information in his working paper file for the purpose of reporting in the format provided in the e-filing utility:-

Sr No	Name and status of the person to whom shares have been issued	PAN of person, if available	Nature of shares (Quoted in RSE/Quoted in URSE/ unquoted equity shares etc.)	No. of Shares issued	Consideration received	Fair Market value as per Rule 11UA(1) (c)/11UA (2)	Face value of shares issued	Amount taxable under section 56(2)(viib) (Report the difference (e)-(f), ONLY if (e) is greater than (g), else report "Not Applicable")
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)

48. Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. [Section 69D].

[Clause 30]

48.1 Details of the amount borrowed on hundi (including interest on such amount borrowed) and details of repayment otherwise than by an account payee cheque, are required to be indicated under this clause. In this context, a reference may also be made to Circular No.208 dated 15th November, 1976 and Circular No. 221 dated 6th June,1977 issued by Board explaining the provisions of section 69D - vide **Appendix XIV (Page no. 275)**.

48.2 For this purpose, the tax auditor should obtain a complete list of borrowings and repayments of hundi loans otherwise than by account payee cheques and verify the same with the books of account.

48.3 There will be practical difficulties in verifying the loan taken or repaid on hundi by account payee cheque. In such cases, the tax auditor should verify the borrowing/repayments with reference to such evidence which may be available and in the absence of conclusive or satisfactory evidence or the auditor may obtain suitable certificate/ management representation in this regard.

48.4 The tax auditor should maintain the following information in his working papers for the purpose of reporting against the said clause in the format provided in the e-filing utility:

Sr. No.	Name of the concerned person	PAN of (b) if available	Address of (b)	Amount borrowed	Date of borrowing	Amount due including interest	Amount repaid	Date of repayment
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)

49. (a)* Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year :-

- (i) name, address and permanent account number (if available with the assessee) of the lender or depositor;
- (ii) amount of loan or deposit taken or accepted;
- (iii) whether the loan or deposit was squared up during the previous year;
- (iv) maximum amount outstanding in the account at any time during the previous year;
- (v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

*(These particulars need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)

50. (b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year:-

- (i) name, address and permanent account number (if available with the assessee) of the payee;
- (ii) amount of the repayment;

- (iii) **maximum amount outstanding in the account at any time during the previous year;**
 - (iv) **whether the repayment was made otherwise than by account payee cheque or account payee bank draft.**
- 51. (c) Whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents**

(The particulars (i) to (iv) at (b) and comment at (c) above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act.)

[Clause 31 (a), (b) and (c)]

49. Clause 31(a)

49.1 Section 269SS prescribes the mode of taking or accepting certain loans and deposits. As per this section, no person shall take or accept from any other person any loan or deposit otherwise than by an account payee cheque or account payee bank draft if,-

- (a) the amount of such loan or deposit or the aggregate amount of such loan and deposit; or
- (b) on the date of taking or accepting such loan or deposit, any loan or deposit taken or accepted earlier by such person from the depositor is remaining unpaid (whether repayment has fallen due or not), the amount or the aggregate amount remaining unpaid; or
- (c) the amount or the aggregate amount referred to in clause (a) together with the amount or the aggregate amount referred to in clause (b),
is twenty thousand rupees or more.

49.2 For the purposes of section 269SS "loan or deposit" means loan or deposit of money.

49.3 Particulars of each loan or deposit falling within the scope of this section as mentioned above taken or accepted during the previous year have to be stated under this sub-clause. This sub-clause requires five specific particulars in respect of each loan or deposit including the permanent account number of the lender, if available.

49.4 The tax auditor should obtain the above details from the assessee in respect of each loan or deposit and verify the same from the records maintained by him.

49.5 If the total of all loans/deposits from a person exceed Rs.20,000/- but each individual item is less than Rs.20,000/-, the information will still be required to be given in respect of all

such entries starting from the entry when the balance reaches Rs.20,000/- or more and until the balance goes down below Rs.20,000/-. As such the tax auditor should verify all loans/deposits taken or accepted where balance has reached Rs.20,000 or more during the year for the purpose of reporting under this clause.

49.6 There will be practical difficulties in verifying the loan or deposit taken or accepted by account payee cheque or an account payee bank draft. In such cases, the tax auditor should verify the transactions with reference to such evidence which may be available. In the absence of satisfactory evidence, the guidance given by the Council of the Institute of Chartered Accountants of India to the tax auditors has been to make a suitable comment in his report as suggested below.

“It is not possible for me/us to verify whether loans or deposits have been taken or accepted otherwise than by an account payee cheque or account payee bank draft, as the necessary evidence is not in the possession of the assessee”.

49.7 The tax auditor has to take into account the technological advancements in the field of banking and information technology where loans have been taken other than through an account payee cheque or bank draft which are capable of being tracked such as bank transactions made electronically through the internet or through mail transfer or telegraphic transfer. These types of payments, though not made by account payee cheques in the conventional manner are capable of being tracked. In order to judicially apply the provisions of section 269SS, the tax auditor need not report such cases under this clause. The Finance (No.2) Act, 2014 has acknowledged the fact and allowed the “use of electronic clearing system through a bank account” as a permissible mode for the purposes of section 269SS .

49.8 For the purposes of this clause, the tax auditor may keep in mind the following typical situations:

- (i) Sale proceeds collected by the selling agent will not be considered as loan or deposit.
- (ii) A current account is not excluded from the definition of the term “deposit”. Therefore, if the transactions in a current account exceed the amount of Rs.20,000/-, it will be necessary to give the information against this sub-clause. This is the position even if no interest is paid on current account.
- (iii) When there is a mixed account, the transactions relating to loans and deposits (temporary advances) should be segregated from other accounts and the transactions relating to loans and deposits (including temporary advances) should be stated under this clause.
- (iv) Advance received against agreement of sale of goods is not a loan or deposit.
- (v) Opening credit balance of loan taken in earlier years is not specifically required to be disclosed. However, while giving figures of maximum amount outstanding at any time during the year or while giving information about acceptance and repayment of

III.310 Auditing Pronouncements

loan/deposit, the opening balances in the loan accounts will have to be taken into consideration.

- (vi) Even if the loans are taken free of interest the information will still have to be given.
- (vii) Security deposits against contracts, etc. will be covered by the definition of 'deposit' and therefore, such information will have to be given. However, the amount retained by the contractee against performance of contract will not be covered as loans/deposits for reporting as amount is not received.
- (viii) Loans and deposits taken or accepted by means of transfer entries in the books of account constitute acceptance of deposits or loans otherwise than by account payee cheques. Hence, such entries have to be reported under this clause. The entries that relate to transactions with a supplier and customer on account of purchase or sale of goods/services will not be treated as loans or deposits accepted.
- (ix) Share application money advance supported by appropriate documentation is neither deposit nor loan and subsequent allotment of shares or repayment of application money as a part of allotment process does not alter the character of application money and provision of Section 269SS/T are not attracted in such a case. *Rugmini Ram Ragav Spinners P. Ltd. 304 ITR 417 Madras High Court and IP India P. Ltd. 343 ITR 353 and Numero Uno Financial Services P. Ltd. 345 ITR 84 Delhi High Court* However, contrary view has been taken in *Bhalotia Engineering Works (P) Ltd. 275 ITR 399*

49.9 As per the proviso to section 269SS, the provisions of section 269SS shall not apply to any loan or deposit taken or accepted from, or any loan or deposit taken or accepted by,-

- (a) Government;
- (b) any banking company, post office savings bank or co-operative bank;
- (c) any corporation established by a Central, State or Provincial Act;
- (d) any Government company as defined in section 2(45) of the Companies Act, 2013; Section 617 of the Companies Act, 1956 has been replaced with section 2(45) in the Companies Act, 2013 with effect from 1.4.2014.
- (e) such other institution, association or body or class of institutions, associations or bodies which the Central Government may, for reasons to be recorded in writing, notify in this behalf in the Official Gazette.

49.10 The footnote in clause 31(a) states that the particulars required under this sub-clause need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act. This is in accordance with the proviso to section 269SS mentioned above. As such, information about loans or deposits taken or accepted from or any loan or deposit taken or accepted by Government, banking company, etc. need not be reported under this sub-clause.

49.11 The auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

Sr. No.	Name of the lender or depositor	Address of the lender or depositor	PAN of the lender or depositor, if available	Amount of loan or deposit taken or accepted	Whether the loan/deposit was squared up during the previous year	Maximum amount outstanding in the account at any time during the Previous year	Whether the loan/ deposit was taken or accepted otherwise than by an account payee bank cheque or account bank draft
1	2	3	4	5	6	7	8

These particulars need not be given in case of a Government Company, a banking company or a corporation established by a Central, State or Provincial Act.

50. Clause 31(b)

50.1 This sub-clause requires particulars of each repayment of loan or deposit in an amount exceeding the limits specified in section 269T made during the previous year. Section 269T after amendment by the Finance Act, 2002 w.e.f. 1.6.2002 is now applicable to repayment of both loans and deposits. Section 269T is attracted where repayment of the loan or deposit is made to a person, where the aggregate amount of loans or deposits held by such person either in his own name or jointly with any other person on the date of such repayment together with interest, if any, payable on such deposit is Rs.20,000 or more. Explanation (iii) contains a definition of the term "loan or deposit" for the purposes of section 269T. Accordingly, "loan or deposit" means any deposit of money which is repayable after notice or repayable after a period and, in the case of a person other than a company, includes loan or deposit of any nature. As such, all repayments made to any person where the loan or deposit along with interest is Rs.20,000 or more are to be reported under this sub-clause, even though the amount of repayment may be less than Rs.20,000. The tax auditor should verify such repayments and report accordingly.

50.2 The second proviso to section 269T inserted by the Finance Act, 2003 w.e.f. 1.6.2002 excludes repayments of loans taken from Government, Government company, Banking company, Corporation established by a Central, State or Provincial Act etc from the scope of the above section and therefore the tax auditor need not report such repayments in his report. However, section 269T does not exclude Government companies, banking companies from

III.312 Auditing Pronouncements

the scope of its applicability. As such, details of repayment are to be shown in the case of these entities also.

50.3 In the case of company assessee loan or deposit is defined to mean deposit repayable after notice or loan or deposit repayable after a period. Therefore, in case of a company loan or deposit repayable on demand will not be considered for the purpose of this section as loan or deposit.

50.4 However, in the case of non-company assessee loan or deposit is defined to mean loan or deposit of any nature. This distinction will have to be kept in mind while giving information under this sub-clause.

50.5 Loan or deposits discharged by means of transfer entries in the books of account constitute repayment of loan or deposits otherwise than by account payee cheques or account payee bank drafts. Hence, such entries have to be reported under this clause.

50.6 The tax auditor has to take into account the technological advancements in the field of banking and information technology where loans have been repaid other than through an account payee cheque or bank draft which are capable of being tracked such as bank transactions made electronically through the internet or through mail transfer or telegraphic transfer. These types of payments, though not made by account payee cheques in the conventional manner, are capable of being tracked. In order to judicially apply the provisions of section 269T, the tax auditor need not report such cases under this clause. The Finance (No.2) Act, 2014 has acknowledged the fact and allowed the "use of electronic clearing system through a bank account" as a permissible mode for the purposes of section 269T. The entries that relate to transactions with a supplier and customer on account of purchase or sale of goods /services will not be treated as loans or deposits repaid.

50.7 The monetary limit of Rs. 20,000 or more is applicable in respect of a banking company or a cooperative bank with reference to each branch and in all other cases assessee as a whole.

50.8 The auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

Sr. No.	Name of the payee	Address of the payee	PAN of the payee, if available	Amount of loan or deposit taken or accepted	Amount of the repayment	Maximum amount outstanding in the account at any time during the Previous year	Whether the repayment was made otherwise than by an account payee bank cheque or account bank draft
1	2	3	4	5	6	7	8

51 Clause 31(c)

51.1 Under this sub clause the tax auditor has to comment as to whether the taking or accepting loan or deposit, or repayment of the same through an account payee cheque or an account payee bank draft based on the examination of books of accounts & other relevant documents. .

51.2 In the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act, the particulars (i) to (iv) mentioned in sub-clause (b) of clause 31 and also the comment mentioned above need not be given.

51.3 However, section 269T does not exclude loans repaid by Government companies, banking companies, corporation established by a Central, State or Provincial Act from the scope of its applicability. As such, details of repayment made by such entities are to be shown.

51.4 It may be noted that the new requirement should be made applicable for the loans and the advances which are in excess of Rs 20,000/-. This is evident from a harmonious reading of the clause (c) with the clauses (a) and (b).

51.5 Practically, it may not possible to verify each payment, reflected in the bank statement, as to whether the payment/ acceptance of deposits or loans has been made through account payee cheque, demand draft, pay order or not, it is thus desirable that the tax auditor should obtain suitable certificate from the assessee to the effect that the payments/ receipts referred to in section 269SS and 269T were made by account payee cheque drawn on a bank or account payee bank draft as the case may be. Where the reporting has been done on the basis of the certificate of the assessee, the same shall be reported as an observation in clause (3) of Form No. 3CA and clause (5) of Form No.3CB, as the case may be.

51.6 The tax auditor has to consider the above guidance while reporting against this clause in the format provided in the e-filing utility.

52. (a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available:

Sl No.	Assessment year	Nature of loss / allowance (in rupees)	Amount as returned (in rupees)	Amount as assessed (give reference to relevant order)	Remarks

53. (b) whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.

III.314 Auditing Pronouncements

54. (c) whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, If yes, please furnish the details of the same.

55.(d) whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same.

56.(e) In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year.

[Clause 32(a) to (e)]

52. Clause 32(a)- Details of brought forward loss or depreciation allowance

52.1 The amount of brought forward loss or depreciation allowance is required to be quantified as per return and assessment orders.

52.2 A reporting format is prescribed for the sake of standardization.

52.3 At times while the particular claim for loss/allowance pertains to a particular assessment year as per the return of income, the same may relate to another assessment year as per the assessment order, e.g, Depreciation claim in respect of assets capitalized at the end of the financial year. In those cases, once the assessment order is received, the particulars have to be re-stated with reference to the assessment year to which they relate as per the assessment order. This should be accompanied by suitable explanation in the remarks column.

52.4 Brought forward losses may relate to different heads of income such as property income, profits and gains of business or profession, speculation business or capital gains. Different provisions are contained in sections 32 and 70 to 79 of the Income-tax Act with regard to loss/depreciation under different heads. In the remarks column information about the pending assessment or appellate proceedings or about delay in filing loss returns should be given. For giving the above information, the auditors should study the assessment records i.e. income-tax returns filed, assessment orders, appellate orders and rectification/ revisional orders for the earlier years and ascertain if the figures given in the above clause are correct. Attention of the members is invited to provisions of section 80 read with section 139(3) of the Income-tax Act, 1961. Section 80 provides that notwithstanding anything contained in Chapter VI of the Act, no loss which has not been determined in pursuance of a return filed in accordance with the provisions of sub-section (3) of section 139 shall be carried forward and set off under sub-section (1) of section 72 or sub-section (2) of section 73 or sub-sections (1) or (3) of section 74 or sub-section (3) of section 74A. Besides these, the tax auditor should keep in mind the provisions of section 71B regarding Carry Forward and Set Off of Loss From House Property, section 73A regarding Carry Forward and Set Off of Losses by Specified Business and also section 78 regarding Carry Forward and Set Off of Losses in case of Change in Constitution of Firm or on Succession.

52.5 Any assessment, rectification, revision or appeal proceedings pending at the time of tax audit have to be disclosed in the remarks column by way of information. If consequential orders for any revision/appellate order is yet to be passed, the same can be disclosed along with the impact thereof if material.

52.6 The e filing utility may require additional information regarding the relevant order. The information is required to be disclosed to the extent available. The tax auditor should consider the above guidance for the purpose of reporting under this clause in the format provided in the e-filing utility.

53. Clause 32(b)- Details of change in shareholding, if any

53.1 Section 79 of the Act provides that, notwithstanding anything contained in Chapter VI of the Act, in the case of a company, not being a company in which the public are substantially interested, where a change in shareholding has taken place in a previous year, then no loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year unless on the last day of that previous year and on the last day of the previous year in which the loss was incurred, the shares of the company carrying not less than 51% of the voting power were beneficially held by the same persons.

53.2 This provision shall not apply to a change in the voting power consequent upon:

- (a) the death of a shareholder, or
- (b) on account of transfer of shares by way of gifts to any relative of the shareholder making such gift.
- (c) any change in the shareholding of an Indian company which is subsidiary of a foreign company arising as a result of amalgamation or demerger of a foreign company subject to the condition that 51 per cent of the shareholders of the amalgamating or demerged foreign company continue to remain the shareholders of the amalgamated or the resulting foreign company.

53.3 However, the overriding provisions of section 79 do not affect the set off of unabsorbed depreciation which is governed by section 32(2). [*CIT v Concord Industries Ltd. (1979) 119 ITR 458 (Mad)*], *CIT v. Shri Subbulaxmi Mills Ltd. 249 ITR 795 (SC)*.

53.4 Sub-clause 32(b) requires a statement whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.

53.5 The comparison of the composition of the shareholding is to be done with reference to the last day of the current previous year and the last day of every previous year in which the loss was incurred. The carry forward of the loss incurred in respect of different previous years is to be determined with respect to the individual previous years. Such comparison of the shareholding can be done by referring to the Register of Members.

54. Clause 32(c) – Speculation Loss under section 73 of the Income Tax Act:

54.1 Section 73 of the Act provides for the treatment of losses in speculation business. Section 73(1) provides that any loss, computed in respect of a speculation business carried on by the assessee, shall not be set off except against profits and gains, if any, of another speculation business.

54.2 Section 73(2) further provides that where for any assessment year any loss computed in respect of a speculation business has not been wholly set off under section 73(1), so much of the loss as is not so set off or the whole loss where the assessee had no income from any other speculation business, shall, subject to the other provisions of Chapter VI, be carried forward to the following assessment year, and-

- (i) it shall be set off against the profits and gains, if any, of any speculation business carried on by him assessable for that assessment year; and
- (ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on.

54.3 Section 73(3) provides that in respect of allowance on account of depreciation or capital expenditure on scientific research, the provisions of sub-section (2) of section 72 shall apply in relation to speculation business as they apply in relation to any other business.

54.4 Furthermore, section 73(4) provides that no loss shall be carried forward under this section for more than four assessment years immediately succeeding the assessment year for which the loss was first computed.

54.5 *As per Explanation 2 to section 28.*—Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (hereinafter referred to as "speculation business") shall be deemed to be distinct and separate from any other business.

54.6 As per section 43(5) "speculative transaction" means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips :

Provided that for the purposes of this clause—

- (a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or
- (b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or

- (c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; or
- (d) an eligible transaction in respect of trading in derivatives referred to in clause (ac) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognised stock exchange; or
- (e) an eligible transaction in respect of trading in commodity derivatives carried out in a recognised association, which is chargeable to commodities transaction tax under Chapter VII of the Finance Act, 2013 ,

shall not be deemed to be a speculative transaction.

54.7 Having regard to the definition of “speculative Business”, the tax auditor has to verify from the books of account and other relevant documents as to whether the assessee is carrying on any speculation business. On verification if the auditor is of the opinion that the auditee is carrying on speculation business, under this clause, the tax auditor has to furnish the details regarding speculation loss referred to in section 73, if any incurred by the assessee during the previous year. Attention is invited to Para 16.3(b) of this Guidance Note.

54.8 The tax auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

S. No.	Nature of loss	Amount of loss for the current year	Brought forward loss of the earlier year(s)	Total loss to be carried forward to the subsequent year	Break- up of the speculation loss in terms of the number of years for which it has been carried forward	Whether the speculation loss has been set off against any other income other than profit & loss, if any, of speculation business
1	2	3	4	5	6	7

55. Clause 32(d) – Details of Losses incurred in respect of a Specified business as referred to under section 73A

55.1 Section 73A provides for provisions relating to carry forward and set off of losses by specified business. It provides that any loss, computed in respect of any specified business referred to in section 35AD shall not be set off except against profits and gains, if any, of any other specified business.

55.2 Section 73A(2) provides that where for any assessment year any loss computed in respect of the specified business referred to in sub-section (1) has not been wholly set off

III.318 Auditing Pronouncements

under sub-section (1), so much of the loss as is not so set off or the whole loss where the assessee has no income from any other specified business, shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

- (i) it shall be set off against the profits and gains, if any, of any specified business carried on by him assessable for that assessment year; and
- (ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on.]

55.3 Under clause 32(d), the tax auditor has to verify from the books of accounts and other relevant documents as to whether the assessee is carrying on specified business as referred to under section 35AD. In case the auditor is of the opinion that the assessee is carrying on such specified business, he has to furnish the details of the loss incurred, if any, in respect of any specified business during the previous year. In case the assessee carries on more than one specified businesses and loss has been incurred in both the business, the details of the loss incurred with respect of each business is to be specified separately.

55.4 The tax auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

Sr. No.	Nature of specified business	Amount of loss incurred, if any, during the previous year, with regard to the specified business mentioned in (b)	Loss from specified business brought forward from the earlier year	Amount of loss being set off against other specified business	Year of loss	Amount of loss being carried forward to the next assessment year ((c) – (d))	Whether loss set off against any other income other than from specified business as per sec. 35AD of the Act.
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)

56. Clause 32(e) – Details of speculation loss, if any, incurred from deemed Speculation business as referred to in Explanation to section 73:

56.1 The Explanation to section 73 provides that where any part of the business of a company (other than a company whose gross total income consists mainly of income which is chargeable under the heads " Interest on securities", " Income from house property", " Capital gains" and " Income from other sources" or a company the principal business of which is the business of trading in shares or banking or the granting of loans and advances) consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares. The Finance Act, 2014 has

amended the explanation to section 73 by deleting the words “the principal business of which is the business of trading in shares” from financial year 2014-2015.

56.2 Under this clause, the tax auditor has to furnish the details regarding the speculation losses incurred, if any, as referred in explanation to section 73. The auditor may obtain information in the following format from the assessee and verify the same from the books of account, income tax returns of earlier years and other relevant documents:

Sr No	Applicable section	Nature of loss	AY of incurring loss	Amount of Loss	Amount set off during current AY	Amount to be carried forward
1	2	3	4	5	6	7

56.3 The above information so maintained may be used by the tax auditor for the purpose of reporting against this clause in the format provided in the e-filing utility.

57. Section-wise details of deductions, if any, admissible under Chapter VIA or Chapter III (Section 10A, Section 10AA).

Section under which deduction is claimed	Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules, 1962 or any other guidelines, circular, etc, issued in this behalf.

[Clause 33]

57.1 Chapter VIA of the Act deals with various deductions which have to be given effect to by way of allowance from gross total Income of the assessee and they have been categorised under the Act as follows:

- A. Deduction in respect of certain payments.
- B. Deduction in respect of certain incomes.
- C. Other Deductions.

While Chapter III relates to Income which do not form part of total income, the reporting under this clause is required only with respect to exemptions claimed under section 10A (Special provisions in respect of newly established undertakings in free trade Zone etc) and section 10AA (Special provisions in respect of newly established units in Special Economic Zones)

III.320 Auditing Pronouncements

57.2 As stated earlier, the tax audit report in Form No.3CA/3CB relates to business or professional activity of the assessee covered by section 44AB. Form No.3CD is an annexure to this Form giving particulars relating to the business/profession covered by the tax audit report. Therefore, the requirement under clause 33 relating to the deductions admissible under Chapter VIA, section 10A and section 10AA will have to be with reference to the items appearing in the books of accounts audited by the tax auditor. If the tax auditor is issuing tax audit report in respect of the accounts of a specific branch or a specific unit he will have to examine the particulars relating to deduction admissible under Chapter VIA and exemption relating to section 10A/10AA, as the case may be, with reference to the books of account of that branch or that unit which is audited by him. Similarly when the tax auditor is issuing report regarding tax audit of the head office he will have to take into consideration the tax audit reports of the branches as well as other units of the assessee which may have been audited by the other tax auditors. He will have to consider the particulars of deductions admissible under Chapter VIA and exemption relating to section 10A/10AA, as the case may be with reference to the particulars given by the tax auditor of other branches/units and also particulars of such deductions from books of the head office.

57.3 In the case of a sole proprietor being an individual or HUF it may so happen that the tax auditor is auditing the accounts of the business/profession and the sole proprietor is having other activities and other sources of income in respect of which tax audit is not mandatory. In such cases the particulars of deductions admissible under Chapter VIA will have to be given with reference to the items appearing in the books of accounts of the business/profession which is subject to audit under section 44AB.

57.4 The admissibility of the aforesaid deductions/exemptions is dependent upon various conditions laid down in the section under which deduction/exemption is admissible. It is, therefore, advised that while working out the amount of admissible deduction the tax auditor has to ascertain that those condition stand fulfilled or not. For ascertaining this, the tax auditor has to obtain all necessary evidence which would enable him to express the opinion regarding the admissibility of deductions. For example, under section 80IA one of the conditions is that the new Industrial undertaking which qualifies for deduction thereunder should not have been formed by splitting up or by the reconstitution of a business already in existence or by transfer to a new business of machinery or plant previously used for any purpose. In order to ascertain the fulfillment of this condition the tax auditor may have to check all documentary evidence in respect of plant and machinery installed in the industrial undertaking to arrive at the conclusion that plant and machinery is new and has not been used previously for any other purpose. Likewise if there is any condition which qualifies the admissibility of the amount of deduction, the tax auditor has to see and ascertain that those qualifying conditions are fulfilled on the basis of documentary evidence available with the assessee. There may be cases where there is difference between the amount claimed by the assessee and the amount computed out by the tax auditor. In such cases it is quite possible that the client's claim is based on some judicial pronouncement on the subject. In such case it may be advisable for the tax auditor to report the amount admissible. The amount claimed and the background

behind and the basis of the claim of the assessee may form part of the working papers. If the claim of the assessee is well-founded and settled by judicial pronouncement the tax auditor may accept the claim but he has to record in his working papers that admissible amount has been reported on the basis of such judicial pronouncement.

57.5 It may be noted that there are certain sections under Chapter VIA like section 80-IA, 80-IB, 80-JJA etc. where separate audit report or certificate is required to be issued. Under the said sections, a non-corporate assessee who has income from industrial undertaking covered under the above sections has also to obtain audit report with reference to the accounts of these undertakings. While giving information with regard to the deduction allowable under these sections the tax auditor should refer to separate audit reports/ certificates obtained by the assessee. These audit reports/ certificates may have been given by the tax auditor or by any other auditor. The figures given in this separate audit reports/certificates should be taken into consideration while giving information with regard to income covered by these sections.

57.6 Since the details of exemptions admissible under sections 10A and 10AA are also to be reported in the desired format, the said information can be verified from the certificate issued by the chartered accountant in this regard. In case, a report under section 10A and 10AA has been issued by any other chartered accountant, then the same may be taken into consideration while reporting under this clause. Here attention is invited to SA-600, *Using the work of another auditor*.

57.7 Some sections in Chapter VIA such as section 80-G (donations), Section 80-GGB/80-GGC (contributions to political parties), section 80-JJAA (wages of new workmen) etc. relate to the expenditure incurred by an assessee. There are other sections such as section 80-P (income of co-operative societies), 80-JJA (certain specified business relating treatment of biodegradable waste) etc. which relate to income of the assessee. In respect of all these sections the tax auditor should ascertain whether there is any expenditure or income covered by the above sections recorded in the books of accounts audited by him. Information with regard to such expenditure/income in respect of deduction allowable under Chapter VIA should be given on the basis of the examination of the books of account and other records under clause 33.

58. (a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:

Tax deduction and collection Account Number (TAN)	Section	Nature of payment	Total amount of payment or receipt of the nature specified in column (3)	Total amount on which tax was required to be deducted or collected out of (4)	Total amount on which tax was deducted or collected at specified rate out of (5)	Amount of tax deducted or collected out of (6)	Total amount on which tax was deducted or collected at less than specified rate out of (7)*	Amount of tax deducted or collected on (8)	Amount of tax deducted or collected not deposited to the credit of the Central Government out of ** (6) and *** (8)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

[Clause 34(a)]

*Should be read as (5) for proper reporting

III.322 Auditing Pronouncements

** Should be read as (7) for proper reporting

*** Should be read as (9) for proper reporting

59. (b) Whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details:

Tax deduction and collection Account Number (TAN)	Type of Form	Due date for furnishing	Date of furnishing, if furnished	Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported

60. (c) whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish:

Tax deduction and collection Account Number (TAN)	Amount of interest under section 201(1A)/206C(7) is payable	Amount paid out of column (2) along with date of payment.

[Clause 34(a), (b) and (c)]

58. Clause 34(a)

58.1 While reporting under this clause the tax auditor may exercise his judgement in the light of the applicable laws and report accordingly about the applicability of the provisions of Chapter XVII-B or XVII-BB with regard to the auditee. The tax auditor may rely upon the judicial pronouncements while taking any particular view. While answering the issue of applicability of the provisions of Chapter XVII-B and/or XVII-BB, a number of debatable issues may arise before the assessee as well as the tax auditor. Where it is not possible to say yes/no, the answer to the question may have to be qualified depending upon the facts and circumstances of each case. Having verified the applicability of the provisions of Chapter XVII-B and Chapter XVII-BB, the tax auditor should answer the question as "Yes" and thereafter provide further details. Where the tax auditor is of the opinion that provisions of Chapter XVII-B and Chapter XVII-BB are not applicable he should answer the question as "No".

58.2 Once the tax auditor gives his affirmation with regard to applicability of the provisions of Chapter XVII-B and/ or Chapter XVII-BB, he is required to furnish further details in Clause 34(a). The auditor should obtain a copy of the TDS/TCS returns filed by the assessee which shall form the basis of reporting under this clause, to the extent possible. Further, in view of the voluminous nature of the transactions, the tax auditor can apply test checks and compliance tests on the transactions reported in the TDS return by the assessee for verifying the information required to be provided under this clause.

58.3 Column (1) of Clause 34(a) requires reporting of each Tax deduction and collection Account number with regard to which tax has been deducted or collected at source.

58.4 In column (2), the tax auditor is required to furnish the details of the applicable section in respect to which tax has been deducted or collected at source

58.5 In column (3), the tax auditor is required to furnish the details regarding the nature of payment.

58.6 In column (4), the auditor is required to furnish the details of the total amount of payment or receipt of the nature specified in column (3). The details in the said column may be drawn from the TDS/TCS statements furnished by the assessee to the Department along with the books of accounts and other relevant documents which include aggregate of payments on which tax is liable to be deducted as well as not liable to be deducted. Auditor may maintain working paper giving reconciliation of amount as per books of accounts and amount on which is TDS/TCS is required to be deducted/collected.

58.7 Column (5) casts an onerous responsibility on the auditor, wherein he is required to furnish the details of total amount on which the tax was required to be deducted or collected out of the amount mentioned in column (4) having regard to the nature of payments/ receipts under the relevant sections of Chapter XVII-B / XVII-BB. Since the reporting under column (4) is required to be made with regard to the nature of payments made or amount received, there may be a difference in the amounts reported under column (4) and column (5). The reasons for difference may be applicability of certificates issued under section 195/197 or threshold limits provided in specific sections or difference of opinion with regard to applicability of a particular section and the like.

58.8 While answering the issue of applicability of the provisions of Chapter XVII-B and/or XVII-BB, a number of debatable issues may arise before the assessee as well as the tax auditor. The auditor may have a difference of opinion with regard to the applicability of the provisions of TDS/TCS on a particular payment. In such a case, the tax auditor has to bring the difference of opinion appropriately as an observation in the clause (3) of Form No. 3CA or clause (5) of Form No.3CB as the case may be.

58.9 It is essential to note that it is the primary responsibility of the assessee to prepare the information in such a manner that the tax auditor can verify the compliance as required in the new clause. The tax auditor is required to verify that no items have been omitted in the

III.324 Auditing Pronouncements

information furnished to him and reasonable test checks would reveal whether or not the information furnished is correct. The extent of check undertaken would have to be indicated by the tax auditor in his working papers and audit notes. The tax auditor would be well advised to so design his tax audit programme as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

58.10 In column (6) the tax auditor is required to furnish the total amount out of the amount deductible or collectible as mentioned in column (5) at which the tax was deducted or collected at the specified rate. The auditor has to consider the rates of deduction as per the law relevant to the previous year. Further, as per the provisions of sections 195/ 197 certificate can be issued for no deduction or lower deduction of tax at source. The tax auditor should refer to the relevant provisions, rules, circulars, notifications and such certificates obtained from the auditee to verify the cases where tax has been short deducted at source. In case the payer deducts/recipient collects tax at source at a rate lower than the specified rate on the basis of certificate issued under section 195 or 197, the lower rate or nil rate, as the case may be will be considered as the specified rate for the purpose of reporting under this clause. In the case of payment to non-residents the applicable rate of tax deduction at source is to be read along with the Double Taxation Avoidance Agreement. Column (7) requires furnishing of total amount of tax deducted/collected out of the amount furnished in column (6).

58.11 Similarly, column (8) requires the tax auditor to furnish the total amount out of the amount deductible or collectible as mentioned in column (5) at which the tax was deducted or collected at the rate less than the specified rate. The lesser deduction is required to be reported in this clause. This will include deduction at a lower rate than what is prescribed, application of wrong section for deduction of tax at source, etc. For example section 194C requires deduction @2% in case payment is made to a person other than individual or HUF, but the deductor deducts only 1%, the same has to be reported under this clause. In case there is difference of opinion with regard to rate of deduction or applicability of a particular section, the auditor may appropriately report the difference of opinion in the clause (3) of Form No. 3CA or clause (5) of Form No.3CB as the case may be giving both the views. Further, column (9) requires furnishing of total amount of tax deducted/collected out of the amount furnished in column (8).

58.12 Column (10) requires the auditor to furnish the details of the amount of tax deducted or collected but not deposited to the credit of the Central Government. As such the tax auditor should verify the cases where the tax has been deducted at source but not paid to the credit of the Central Government till the date of the audit. It may be seen that tax deducted but deposited late will not be required to be reported in this clause.

58.13 The details in the column (6), (7), (8), (9) and (10) may be drawn from the TDS/TCS returns furnished by the assessee to the Department and be verified from the books of accounts and other relevant documents.

59. Clause 34(b)

59.1 Under clause 34(b), the tax auditor has to ascertain and report as to whether the assessee has furnished the statement of tax deducted or tax collected at source within the prescribed time. If all the TDS/TCS statement(s) relating to the previous year have been filed within the prescribed time, the auditor has to mention "yes". In case the assessee has not filed any of the quarterly TDS/TCS statement(s) within the prescribed time, the auditor has to mention "No" in this clause. In such a case, the auditor shall provide further details in Clause 34(b) only with regard to the statement not filed within the prescribed time. Clause 34(b) requires the auditor to report the transactions with regard to each TAN for which tax has been deducted but the return has either not been filed or has been filed after the expiry of the prescribed time. With regard to each TAN, the auditor is required to mention the "Type of form" that was applicable like Form 24, 24G, 24Q, 26, 26A, 26B, 26Q etc, due date of furnishing such statement and the actual date of furnishing, if the statement(s) has been furnished. Lastly, the auditor is required to state as to whether the statement of tax deducted or collected, which has been furnished beyond prescribed time contains information about all the transactions which are required to be reported. As stated earlier, it is extremely difficult for the tax auditor to verify each and every transaction in this regard. Therefore, while verifying such transactions, the tax auditor can apply the concepts of materiality and audit sampling. The reporting requirement in clause (b) arises only where the assessee has either not furnished or furnished the statement of tax deducted or tax collected after the expiry of prescribed time.

59.2 In regard to clause 34(b), the tax auditor has to verify the particulars regarding tax deductible and tax collectible from the information furnished by the assessee. The various provisions of Chapter XVII-B and XVII-BB require different classes of assesseees to deduct/collect tax at source on various nature of payments. The tax auditor should consider the applicability of the different provisions relating to tax deduction at source taking into consideration the status of the assessee and the applicability of the relevant provision. As regards the applicability of the provisions the tax auditor should take into consideration the relevant sections, rules, notifications, circulars and various judicial pronouncements in relation to transactions of relevant payments or collections. There may be occasions when the tax auditor may not agree with the interpretation/view taken by the auditee. In such cases the tax auditor may report both the views as an observation in clause (3) of Form No. 3CA or clause (5) of Form No. 3CB, as the case may be

59.3 The information given in clause 34 should tally with the disallowances reported u/s 40(a) in clause 21(b) to the extent applicable.

60. Clause 34(c)

60.1 Under this clause, the auditor is required to furnish detailed information in case the assessee is liable to pay interest under section 201(1A) or section 206C(7) of the Act. Section 201(1A) provides for payment of interest at a specified rate in case the tax has not been deducted wholly or partly or after deducting has not been paid to the credit of Central

III.326 Auditing Pronouncements

Government as required by the Act. Similarly, section 206C(7) provides for payment of interest at a specified rate in case the tax is not collected wholly or partly or if collected not paid to the credit of the Central Government as required by the Act. The reporting as to whether the assessee is liable to pay such interest, should be in consonance with the reporting under clause 34(a) where the details of non-deduction are required to be reported by him.

60.2 Where the assessee is liable to pay interest u/s 201(1A) or 206C(7), the auditor should verify such amount from the books of account as on 31st March of the relevant previous year and also from PART G of the statement generated by the Department in Form No.26AS. In case the the assessee had disputed the levy or calculation of interest under TRACES, in Form No.26AS, the auditor may re-calculate the amount of interest under section 201(1A) or section 206C(7) up to the date of audit report for reporting under this clause and also mention the fact in his observations paragraph provided in Form No.3CA or Form No.3CB, as the case may be.

- 61. (a) In the case of a trading concern, give quantitative details of the principal items of goods traded:**
- (i) Opening stock;
 - (ii) Purchases during the previous year;
 - (iii) Sales during the previous year;
 - (iv) Closing stock;
 - (v) shortage / excess, if any.
- 62. (b) In the case of a manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products :**
- A. Raw materials:**
 - (i) opening stock;
 - (ii) purchases during the previous year;
 - (iii) consumption during the previous year;
 - (iv) sales during the previous year;
 - (v) closing stock;
 - (vi) yield of finished products;
 - (vii) percentage of yield;
 - (viii) shortage/excess, if any.
 - B. Finished products/By-products:**
 - (i) opening stock;
 - (ii) purchases during the previous year;

- (iii) quantity manufactured during the previous year;
- (iv) sales during the previous year;
- (v) closing stock;
- (vi) shortage/excess, if any.

[Clause 35 (a) and (b)]

61. Clause 35(a)

61.1 The tax auditor should obtain certificates from the assessee in respect of the principal items of goods traded, the balance of the opening stock, purchases, sales and closing stock and the extent of shortage/ excess/damage and the reasons thereof.

62. Clause 35(b)

62.1 This information should be given only in respect of those items where it is practicable to do so, having regard to the records maintained by the assessee.

62.2 In a large concern it may be difficult for tax auditor to verify each and every item of purchase, consumption and production. In such cases, he may verify the figures on a sampling method and satisfy himself as to the correctness of the figures furnished. This clause requires that quantitative details of "principal items" of raw materials and finished goods should be given. Therefore, information about petty items need not be given. What would constitute principal items will depend on the facts of each case. Normally, items which constitute more than 10% of the aggregate value of purchases, consumption or turnover may be classified as principal items.

62.3 The information about 'yield', 'percentage of yield', and 'shortages/ excess' is also required to be given.

62.4 In respect of assesseees other than companies and those whose accounts have not been audited under any other law, the tax auditor should obtain the following certified documents for the principal items of raw materials, finished goods and by-products:

- (a) Certificate from the assessee certifying the balance of the opening stock, purchases, sales and closing stock.
- (b) Certificate to the extent of shortage/excess/damage and the reasons thereof.

62.5 By-products represent products whose manufacture results incidentally from the manufacture of the main product or where the waste arising in the manufacture of main product is further processed to create a by-product. Where the by product so produced or is continuously generated it should be treated for the purpose of sale and disposal at par with at any other product produced by the company and similar records should be maintained. The quantitative details on the above lines are to be given in respect of by-product also.

63. In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form:-

- (a) total amount of distributed profits;**
- (b) amount of reduction as referred to in section 115-O(1A)(i);**
- (c) amount of reduction as referred to in section 115-O(1A)(ii);**
- (d) total tax paid thereon;**
- (e) dates of payment with amounts.**

[Clause 36]

63.1 Section 115-O provides for a special levy at the prescribed rate, on the amount of dividend declared, distributed or paid by such company whether such dividend is out of current profit or accumulated profits. Vide this clause the tax auditor has to report on profit distributed during the financial year and therefore, the amount of tax worked and paid out on such distributed profit at the prescribed rate plus surcharge at the applicable rate on the tax along with the education cess thereon has to be reported against this clause. The amount of the dividend referred to in sub-section (1) is to be reduced by the amount referred to in sub-section (1A). Since the tax is payable on such reduced amount, the gross amount may be reported in the sub-clause (a) and the amount of reduction as referred to in section 115-O(1A)(i) and 115-O(1A)(ii) shall be reported in sub-clause (b) and (c) separately. The tax auditor should keep the working papers to reveal how the net amount has been arrived at.

63.2 It may be noted that for the purposes of chapter XII-D containing special provisions relating to tax on distributed profits of domestic companies the expression “dividends” shall have the same meaning as is given to “dividend” in clause (22) of section 2 but shall not include sub-clause (e) thereof. However, the tax auditor need not go into the question of how the total amount of distributed profits has been arrived at.

63.3 The next requirement is to report the tax paid thereon and the date of payment. The date of payment of tax can be ascertained by the tax auditor from the duly received challan and books of account etc.

63.4 In this clause, the total amount of profits distributed in the previous year, tax paid thereon and the date of payment of tax is required to be given. Information about the date of declaration/distribution of dividend or payment of dividend is not required to be given.

63.5 The tax auditor should maintain the information in the following format for the purpose of reporting in the format provided in the e-filing utility:

S. No.	Total Amount of distributed profits	Amount of reduction as referred to in section 115-O(1A)(i)	Amount of reduction as referred to in section 115-O(1A)(ii)	Total tax paid	Date of payments with Amount	
					Date of Payment	Amount
1	2	3	4	5	6	7

64. Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/ quantity as may be reported/identified by the cost auditor

[Clause 37]

64.1 The tax auditor should ascertain from the management whether cost audit was carried out and if yes, a copy of the same should be obtained from the assessee. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

64.2 In cases where cost audit which might have been ordered is not completed by the time the tax auditor issues his report, he has to report appropriately in this report stating that since cost audit is not completed and the cost audit report is not available with the assessee.

64.3 The tax auditor should examine the time period for which the cost audit if any has been required to be carried out. Information is required to be given only in respect of such cost audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that cost audit report which is received upto the date of tax audit report.

65. Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/ identified by the auditor

[Clause 38]

65.1 The tax auditor should ascertain from the management whether any audit was conducted under the Central Excise Act, 1944 and if such audit was carried out, obtain a copy of the report. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

III.330 Auditing Pronouncements

65.2 In cases where excise audit which might have been ordered is not completed by the time the tax auditor gives his report, he has to report appropriately in this report stating that since excise audit is not completed and the excise audit report is not available with the assessee.

65.3 The tax auditor should examine the time period for which the excise audit, if any, has been required to be carried out. Information is required to be given only in respect of such excise audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that excise audit report which is received upto the date of tax audit report.

66. Whether any audit was conducted under section 72A of the Finance Act, 1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.

[Clause 39]

66.1 The tax auditor should ascertain from the management whether any audit was conducted under section 72A of the Finance Act, 1994 and if such audit was carried out, obtain a copy of the report. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

66.2 In cases where service tax audit, which might have been ordered is not completed by the time the tax auditor gives his report, he has to report appropriately in this report stating that since service tax audit is not completed and the service tax audit report is not available with the assessee.

66.3 The tax auditor should examine the time period for which the service tax audit, if any, has been required to be carried out. Information is required to be given only in respect of such service tax audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that service tax audit report which is received upto the date of tax audit report.

67. Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:

Serial number	Particulars	Previous year	Preceding previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		

4.	Stock-in-trade/turnover		
5.	Material consumed/finished goods produced		

(The details required to be furnished for principal items of goods traded or manufactured or services rendered)

[Clause 40]

67.1 These ratios have to be calculated only for assesseees who are engaged in manufacturing or trading activities. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in (5) need not be given for trading concern or service provider.

67.2 While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles. All the ratios mentioned in this clause are to be calculated in terms of value only.

67.3 The following definitions given by the ICAI in its Guidance Note on the Terms Used in Financial Statements may be noted.

- (a) **Gross Profit:** The excess of the proceeds of goods sold and services rendered during a period over their cost, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as gross loss.
- (b) **Turnover:** The aggregate amount for which sales are effected or services rendered by an enterprise. The terms gross turnover and net turnover (or gross sales and net sales) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts. Attention is also invited to Para 5 (Sales, Turnover, Gross receipts) of this Guidance Note.
- (c) **Net Profit:** The excess of revenue over expenses during a particular accounting period. When the result of this computation is negative, it is referred to as net loss. The net profit may be shown before or after tax.

It may be noted that the net profit to be shown here in this clause is net profit before tax.

67.4 For the purpose of calculating the ratio mentioned in (4), only closing stock is to be considered. The term 'stock-in-trade' used therein does not include stores and spare parts or loose tools. The term "stock-in-trade" would include only finished goods and would not include the stock of raw material and work-in-progress since the objective here is to compute the stock-turnover ratio.

67.5 Material consumed would, apart from raw material consumed, include stores, spare parts and loose tools.

III.332 Auditing Pronouncements

67.6 The value of finished goods produced may be arrived at by using the following formula:

(a) Raw material consumption	-
(b) Stores and spare parts consumption	-
(c) Wages	-
(d) Other manufacturing expenses excluding depreciation.	-
Sub total	-
Add : Opening stock in process	-
Deduct : Closing stocks in process-	
Value of finished goods produced	

67.7 Under this clause, calculation of the ratios are also to be stated. As such, computation of various components based upon which these ratios have been worked out is required to be stated under this clause. However, if any of the above component is stated in the financial statements themselves, a reference to the same may be made, to the extent possible.

67.8 There should be consistency between the numerator and the denominator while calculating the above ratios. Any significant deviation thereof should be pointed out.

67.9 The relevant previous year figures are to be taken from last previous year audit report. In case the preceding previous year is not subject to audit, nothing should be mentioned in the relevant column.

68. Please furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 along with details of relevant proceedings.

[Clause 41]

68.1 The auditee may be assessed under various tax laws other than Income-tax Act, 1961 and Wealth-tax Act, 1956 resulting into a demand order or a refund order. The tax auditor should obtain a copy of all the demand/ refund orders issued by the governmental authorities during the previous year under any tax laws other than Income Tax Act and Wealth Tax Act. Normally, the Indirect tax laws such as Central Excise Duty, Service Tax, Customs Duty, Value Added Tax, CST, Professional Tax etc would be covered as other tax laws. Hence, the cess or duty like Marketing Cess, Cess on Royalty, Octroi Duty, Entry Tax etc. would not be covered as other tax laws. However, the auditor should exercise his professional judgment in determining the applicability to relevant tax laws for reporting under this clause.

68.2 It may be noted that even though the demand/refund order is issued during the previous year, it may pertain to a period other than the relevant previous year. In such cases also, reporting has to be done under this clause. . The tax auditor should verify the books of account and the orders passed by the respective Department for ascertaining whether any

such demand has been raised or refund order has been issued under any other tax law and accordingly report the same. If there is any adjustment of refund against any demand, the auditor shall also report the same under this clause.

68.3 The tax auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

S. No.	Name of the applicable Act	Demand/ Refund Order No., if any	Date of Demand raised/ refund issued	Financial Year to which the Demand / refund relates	Amount of demand raised/ refund issued	Adjustment of refund against demand, if any	Remarks
1	2	3	4	5	6	7	8

69. Signature and stamp/Seal of the signatory

69.1 Form 3CD has to be signed by the person competent to sign Form No. 3CA or Form No.3CB as the case may be. He has also to give his full name, address, membership number, firm registration number, wherever applicable, place and date. Further, the e-filing portal requires the tax auditor to affix his Digital Signature while registering himself. He is also required to put his stamp/Seal as well.

70. Code of Ethics and other matters

70.1 Some of the issues which are commonly raised in regard to different aspects of tax audit vis-à-vis the liability/ obligations of the tax auditor are considered hereunder.

70.2 The liability of the tax auditor in respect of tax audit will be the same as in any other audit assignment. It may be noted that when any question relating to the audit conducted by a tax auditor arises, he is answerable to the Council of the Institute under the Chartered Accountants Act. In all matters concerning tax audit, ICAI's disciplinary jurisdiction will prevail.

70.3 In case the assessee is found guilty of having concealed the particulars of his income it would not ipso facto mean that the tax auditor is also responsible. If the Assessing Officer comes to the conclusion that the tax auditor was grossly negligent in the performance of his duties, he can refer the matter to the ICAI so that appropriate action can be taken against the tax auditor under the Chartered Accountants Act.

70.4 The Assessing Officer or any other authority who is authorised to issue summons and to call for evidence or documents, can call upon the tax auditor who has audited the accounts to give any evidence or produce documents. For this purpose notice under section 131 can be issued by the Assessing Officer or other tax authority mentioned in the said section.

70.5 If the actual work relating to examination of books and records is done by a qualified assistant in a firm of chartered accountants and the partner of the firm signing the audit report has relied upon this work, action, if any, for professional negligence can be initiated against the member who has signed the report and in such an event, it would be open for the member

III.334 Auditing Pronouncements

concerned to prove that he has taken due care and diligence in the performance of his duties and is not aware of any reason to believe that he should not have so relied.

70.6 If the qualified assistant (whether or not holding the certificate of practice) is found to be grossly negligent in the performance of his duties, the Council of the Institute can take disciplinary action against him.

70.7 A tax auditor can accept the assignment of tax representation.

70.8 Under the Code of Ethics, no tax auditor can charge professional fees by way of percentage of profits or which are contingent upon findings, or results of such employment, except as permitted under any regulation made under this Act. In this connection, reference is invited to Clause (10) of Part I of the First Schedule to the Chartered Accountants Act and the commentary on the subject at page 210 of the Code of Ethics (2009 Edition). Certain exceptions are made in Regulation 192, but these exceptions do not apply for charging of fees for tax audit.

70.9 Since the figures in Form No. 3CD are duly verified by a chartered accountant, they should normally be accepted by tax authorities. If, however, there is a specific reason for differing from the view taken by tax auditor, the Assessing Officer may compute the income of the assessee by adopting different figures.

70.10 The opinion expressed by the tax auditor is not binding on the assessee. If the tax auditor has qualified his report and expressed an opinion on a particular item, the assessee may take a different view while preparing his return of income. In such cases, it is advisable for the assessee to state his viewpoint and support the same by any judicial pronouncements on which he wants to rely.

71. Format of Financial Statements

71.1 The tax auditor of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited has to give his report in Forms No. 3CB/3CD and will have to ensure that the financial statements i.e. balance sheet and profit and loss account/ income and expenditure statement, are prepared in such a manner that adequate information which is necessary to convey a true and fair view of the state of affairs of the assessee is given. So far as a person whose accounts of the business or profession have been audited under any other law is concerned, the information to be given in the financial statements is normally provided in the particular statute by which the assessee is governed. Since there is no such legislation in respect of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, it is necessary to achieve some uniformity in respect of information to be provided in the financial statements.

71.2 It should be noted that the responsibility for maintenance of books and records and that for preparation of financial statements is that of the assessee. It is, therefore, desirable that guidance is given to a person who carries on business or profession but who is not required

by or under any other law to get his accounts audited about the maintenance of books of accounts and records as well as about the requirements of auditing. Similarly, guidance is also required to be given about the preparation of financial statements and the information to be provided in such statements. (See “Monograph on Compulsory Maintenance of Accounts” published by ICAI)

71.3 Two separate sets of forms of balance sheet and profit and loss account have, therefore, been prepared and given as Appendices to this Guidance Note. **Appendix XV (Page no. 278)** gives the recommended format of the balance sheet and also the information to be provided in the profit and loss account, in case of an assessee engaged in trading business. This format can be used in the case of an assessee, who is engaged in profession and other service activities, by making such changes as may be considered to suit the circumstances. **Appendix XVI (Page no. 286)** gives the recommended format of the balance sheet and the requirements of the profit and loss account in the case of an assessee engaged in the manufacturing activities. It is suggested that the balance sheet and the profit and loss account can be prepared either in the vertical or in the horizontal form according to the circumstances of each case. If the information required to be given in any item or sub-item of the financial statements cannot conveniently be given on the face of the financial statements, the same may be given by way of footnotes/ annexures to and forming part of such financial statements. Since the formats are designed also for accounts of non-corporate borrowers from banks, they may be modified so as to exclude the information, which may not be relevant for accounts for tax audit. For presentation and disclosure requirements, applicable AS and AS (IT) should be kept in mind.

APPENDICES

NOTE

- ◆ The appendices published hereinafter do not form part of the Statement. These are intended for the ease of reference to the readers.
- ◆ These appendices, among other things, also contain reproduction of texts of various sections of relevant statutes and notifications issued by the Government of India. While every effort has been made to avoid errors or omissions in reproduction, some errors are likely to creep in. It is, therefore, suggested that to avoid any doubt, the reader should cross-check all the facts, law and contents of the publication with original Government publication or notifications.

APPENDIX I

[PARA 5.12]

CIRCULAR NO. 452, DATED 17.3.1986

Subject: Section 44AB of the Income-tax Act, 1961- Clarification regarding applicability in the cases of Commission Agents, arathias etc. (Para 5.12).

1. Section 44AB of the Income-tax Act, 1961, as inserted by the Finance Act, 1984, casts an obligation on every person carrying on business to get his accounts audited, if his total sales, turnover or gross receipts, as the case may be, exceed Rs.40 lakhs (substituted by Rs. 1 crore by Finance Act, 2012 w.e.f. A.Y. 2013-14) in any previous year relevant to the assessment year commencing on 1.4.1985 or any subsequent assessment year.
2. The Board have received representations from various persons, trade associations, etc., to clarify whether in cases where an agent effects sales/turnover on behalf of his principal, such sales/turnover have to be treated as the sales/turnover of the agent for the purpose of Section 44AB of the Income-tax Act, 1961.
3. The matter was examined in consultation with the Ministry of Law. There are various trade practices prevalent in the country in regard to agency business and no uniform pattern is followed by the commission agents, consignment agents, brokers, kachha arhatias and pacca arhatias dealing in different commodities in different parts of the country. The primary necessity in each instance is to ascertain with precision what are the express terms of the particular contract under consideration. Each transaction, therefore, requires to be examined with reference to its terms and conditions and no hard and fast rule can be laid down as to whether an agent is acting only as an agent or also as a principal.

III.338 Auditing Pronouncements

4. Board are advised that so far as kachha arhatias are concerned, the turnover does not include the sales effected on behalf of the principals and only the gross commission has to be considered for the purpose of Section 44AB. But the position is different with regard to pacca arhatia. A pacca arhatia is not, in the proper sense of the word, an agent or even del credere agent. The relation between him and his constituent is substantially that between the two principals. On the basis of various Court pronouncements, following principles of distinction can be laid down between a kachha arhatia and a pacca arhatia:
 - (1) A kachha arhatia acts only as an agent of his constituent and never acts as a principal. A pacca arhatia, on the other hand, is entitled to substitute his own goods towards the contract made for the constituent and buy the constituent's goods on his personal account and thus he acts as a principal as regards his constituent.
 - (2) A kachha arhatia brings a privity of contract between his constituent and the third party so that each becomes liable to the other. The pacca arhatia, on the other hand, makes himself liable upon the contract not only to the third party but also to his constituent.
 - (3) Though the kachha arhatia does not communicate the name of his constituent to the third party, he does communicate the name of the third party to the constituent. In other words, he is an agent for an unnamed principal. The pacca arhatia, on the other hand, does not inform his constituent as to the third party with whom he has entered into a contract on his behalf.
 - (4) The remuneration of kachha arhatia consists solely of commission and he is not interested in the profits and losses made by his constituent as is not the case with the pacca arhatia.
 - (5) The kaccha arhatia, unlike the pacca arhatia does not have any dominion over the goods.
 - (6) The kaccha arhatia has no personal interest of his own when he enters into a transaction and his interest is limited to the commission agent's charges and certain out of pocket expenses whereas a pacca arhatia has a personal interest of his own when he enters into a transaction.
 - (7) In the event of any loss, the kachha arhatia is entitled to be indemnified by his principal as is not the case with pacca arhatia.
5. The above distinction between a kachha arhatia and pacca arhatia may also be relevant for determining the applicability of Section 44AB in cases of other type of agents. In the case of agents whose position is similar to that of kachha arhatia, the turnover is only the commission and does not include the sales on behalf of the principals. In the case of agents of the type of pacca arhatia, on the other hand, the

total sales/turnover of the business should be taken into consideration for determining the applicability of the provisions of Section 44AB of the Income-tax Act.

Circular No. 452 [F.No.201/3/85-IT(A-II) dated 17th March 1986.

JUDICIAL ANALYSIS

EXPLAINED IN - In *Jeyar Consultant & Investment (P.) Ltd. v. Assistant Commissioner* [1993] 46 ITD 71 (Mad.-Trib.), it was observed that it is *ex facie* clear from the CBDT Circular No. 452 of 17-3-1986 which came to be issued in relation to *kacha* and *pacca arhatias*, who are an integral part of the trading sector, that instructions issued by the Board as respects *kacha* and *pacca arhatias* could not be applied to the case of the assessee who has arranged finances for other for a fee. The assessee may choose to label the fee as brokerage or even as commission. But the fee or to use a generic expression 'receipt' could not be regarded as turnover proper.

RELIED ON IN - The above circular was relied on in *ITO v. Shantilal Chunilal & Co.* [1993] 45 ITD 581 (Pune - Trib.), with the following observations:

“ . . . Further, reference was made by assessee to pages 52 to 54 which contains Board's Circular No. 452, dated 17-3-1986 which has been issued in connection with section 44AB of the Income-tax Act, 1961. Reliance was placed on para 4 of the said circular according to which the Board were advised that so far as *kachha arahatias* were concerned, the turnover did not include sales effected on behalf of the principals and only gross commission has to be considered for the purpose of section 44AB. The submission of the learned counsel for the assessee was that the case of the assessee is one of *kachha arahatia* and not a *pucca arahatia* and, therefore, only gross commission has to be considered for the purpose of section 44AB of the Income-tax Act, 1961. . . . The CIT (Appeals) has excluded the adad receipt as well as interest receipt from the purview of turnover for the purpose of section 44AB. Relying on the clarifications given by the Board in its Circular No. 452, dated 17-3-1986, he has categorised the assessee as *kachha arahatia* and he has charged expenses incurred on such business which resulted in gross profit rate of 1.09 per cent. Therefore, it is very much relevant to clinch the issue whether the assessee is a *kachha arahatia* or not. Going by the clarification issued by the Board in the aforesaid Circular No. 452, dated 17-3-1986 the case of the assessee fits in with the *kachha arahatia vis-a-vis* case of *pucca arahatia*. . . .” (pp. 585-586).

REFERRED TO IN - *Manish Textiles v. ACIT* [1991] 38 ITD 365 (Bom.).

Circular No. 4/2007, dated 15th June, 2007

F.No.149/287/2005-TPL

Distinction between shares held as stock-in-trade and shares held as investment - tests for such a distinction

1. The Income-tax Act, 1961 makes a distinction between a “capital asset” and a “trading asset”.
2. Capital asset is defined in Section 2(14) of the Act. Long-term capital assets and gains are dealt with under Section 2(29A) and Section 2(29B). Short-term capital assets and gains are dealt with under Section 2(42A) and Section 2(42B).
3. Trading asset is dealt with under Section 28 of the Act.
4. The Central Board of Direct Taxes (CBDT) through Instruction No.1827 dated August 31, 1989 had brought to the notice of the assessing officers that there is a distinction between shares held as investment (capital asset) and shares held as stock-in-trade (trading asset). In the light of a number of judicial decisions pronounced after the issue of the above instructions, it is proposed to update the above instructions for the information of assessees as well as for guidance of the assessing officers.
5. In the case of *Commissioner of Income Tax (Central), Calcutta Vs Associated Industrial Development Company (P) Ltd (82 ITR 586)*, the Supreme Court observed that:

“Whether a particular holding of shares is by way of investment or forms part of the stock-in-trade is a matter which is within the knowledge of the assessee who holds the shares and it should, in normal circumstances, be in a position to produce evidence from its records as to whether it has maintained any distinction between those shares which are its stock-in-trade and those which are held by way of investment.”
6. In the case of *Commissioner of Income Tax, Bombay Vs H. Holck Larsen (160 ITR 67)*, the Supreme Court observed :

“The High Court, in our opinion, made a mistake in observing whether transactions of sale and purchase of shares were trading transactions or whether these were in the nature of investment was a question of law. This was a mixed question of law and fact.”
7. The principles laid down by the Supreme Court in the above two cases afford adequate guidance to the assessing officers.
8. The Authority for Advance Rulings (AAR) (288 ITR 641), referring to the decisions of the Supreme Court in several cases, has culled out the following principles:

- “(i) Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade and that existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction;
- (ii) the substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions;
- (iii) ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/adventure in the nature of trade; but where the object of the investment in shares of a company is to derive income by way of dividend etc. then the profits accruing by change in such investment (by sale of shares) will yield capital gain and not revenue receipt”.

9. Dealing with the above three principles, the AAR has observed in the case of Fidelity group as under:-

“We shall revert to the aforementioned principles. The first principle requires us to ascertain whether the purchase of shares by a FII in exercise of the power in the memorandum of association/trust deed was as stock-in-trade as the mere existence of the power to purchase and sell shares will not by itself be decisive of the nature of transaction. We have to verify as to how the shares were valued/held in the books of account i.e. whether they were valued as stock-in-trade at the end of the financial year for the purpose of arriving at business income or held as investment in capital assets. The second principle furnishes a guide for determining the nature of transaction by verifying whether there are substantial transactions, their magnitude, etc., maintenance of books of account and finding the ratio between purchases and sales. It will not be out of place to mention that regulation 18 of the SEBI Regulations enjoins upon every FII to keep and maintain books of account containing true and fair accounts relating to remittance of initial corpus of buying and selling and realizing capital gains on investments and accounts of remittance to India for investment in India and realizing capital gains on investment from such remittances. The third principle suggests that ordinarily purchases and sales of shares with the motive of realizing profit would lead to inference of trade/adventure in the nature of trade; where the object of the investment in shares of companies is to derive income by way of dividends etc., the transactions of purchases and sales of shares would yield capital gains and not business profits.”

10. CBDT also wishes to emphasise that it is possible for a tax payer to have two portfolios, i.e., an investment portfolio comprising of securities which are to be treated as capital assets and a trading portfolio comprising of stock-in-trade which are to be treated as trading assets. Where an assessee has two portfolios, the assessee may have income under both heads i.e., capital gains as well as business income.

III.342 Auditing Pronouncements

11. Assessing officers are advised that the above principles should guide them in determining whether, in a given case, the shares are held by the assessee as investment (and therefore giving rise to capital gains) or as stock-in-trade (and therefore giving rise to business profits). The assessing officers are further advised that no single principle would be decisive and the total effect of all the principles should be considered to determine whether, in a given case, the shares are held by the assessee as investment or stock-in-trade.

12. These instructions shall supplement the earlier Instruction no. 1827 dated August 31, 1989.

APPENDIX III

[PARA 9.8]

Mandatory Communication - Relevant Extracts from the Code of Ethics *(In view of the fact that with effect from 01.04.2014 the Companies Act, 1956 has been replaced with Companies Act, 2013, the "Code of Ethics" issued by ICAI is under revision. The members may refer the revised "Code of Ethics" as and when published.)*

(11th Edition - January, 2009)

(Pages 163 to 168)

Clause (8): accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing;

It must be pointed out that professional courtesy alone is not the major reason for requiring a member to communicate with the existing accountant who is a member of the Institute or a certified auditor. The underlying objective is that the member may have an opportunity to know the reasons for the change in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of the existing accountant. It is not intended, in any way, to prevent or obstruct the change. When making the enquiry from the retiring auditor, the one proposed to be appointed or already appointed should primarily find out whether there are any professional or other reasons why he should not accept the appointment.

It is important to remember that every client has an inherent right to choose his accountant; also that he may, subject to compliance with the statutory requirements in the case of limited Companies, make a change whenever he chooses, whether or not the reasons which had impelled him to do so are good and valid. The change normally occurs where there has been a change of venue of business and a local accountant is preferred or where the partner who has been dealing with the clients affairs retires or dies; or where temperaments clash or the client has some good reasons to feel dissatisfied. In such cases, the retiring auditor should

always accept the situation with good grace.

The existence of a dispute as regards the fees may be root cause of an auditor being changed. This would not constitute valid professional reasons on account of which an audit should not be accepted by the member to whom it is offered. However, in the case of an undisputed audit fees for carrying out the statutory audit under the Companies Act, 1956 or various other statutes having not been paid, the incoming auditor should not accept the appointment unless such fees are paid. In respect of other dues, the incoming auditor should in appropriate circumstances use his influence in favour of his predecessor to have the dispute as regards the fees settled. The professional reasons for not accepting an audit would be:

- (i) Non-compliance of the provisions of Sections 224 and 225 of the Companies Act as mentioned in Clause (9);
- (ii) Non-payment of undisputed audit fees by auditees other than in case of sick units for carrying out the statutory audit under the Companies Act, 1956 or various other statutes; and
- (iii) Issuance of a qualified report.

In the first two cases, an auditor who accepts the audit would be guilty of professional misconduct. In this connection, attention of members is invited to the Council Guidelines No. 1-CA/(7)/02/2008 dated 08.08.08 appearing in Chapter-3 of the book and also published at page 686 of October, 2008 issue of the Journal. In the said guidelines, Council has explained that the provision for audit fee in accounts signed by both the auditee or the auditor shall be considered as “undisputed” audit fee and “sick unit” shall mean where the net worth is negative.

In the last case, however, he may accept the audit if he is satisfied that the attitude of the retiring auditor was not proper and justified. If, on the other hand, he feels that the retiring auditor had qualified the report for good and valid reasons, he should refuse to accept the audit. There is no rule, written or unwritten, which would prevent an auditor from accepting the appointment offered to him in these circumstances. However, before accepting the audit, he should ascertain the full facts of the case. For nothing will bring the profession to disrepute so much as the knowledge amongst the public that if an auditor is found to be “inconvenient” by the client, he could readily be replaced by another who would not displease the client and this point cannot be too over-emphasised.

What should be the correct procedure to adopt when a prospective client tells you that he wants to change his auditor and wants you to take up his work? There being two persons involved, the Company and the old auditor, the former should be asked whether the retiring auditor had been informed of the intention to change. If the answer is in the affirmative, then a communication should be addressed to the retiring auditor. If, however, it is learnt that the old auditor has not been informed, and the client is not willing to make the first move, it would be

III.344 Auditing Pronouncements

necessary to ask him the reason for the proposed change. If there is no valid reason for a change, it would be healthy practice not to accept the audit. If he decides to accept the audit he should address a communication to the retiring auditor.

As stated earlier, the object of the incoming auditor, in communicating with the retiring auditor is to ascertain from him whether there are any circumstances which warrant him not to accept the appointment. For example, whether the previous auditor has been changed on account of having qualified his report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. In all these cases it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit, and should he do so, he must also take into account the information while discharging his duties and responsibilities.

Sometimes, the retiring auditor fails without justifiable cause except a feeling of hurt because of the change, to respond to the communication of the incoming auditor. So that it may not create a deadlock, the auditor appointed can act, after waiting for a reasonable time for a reply.

The Council has taken the view that a mere posting of a letter under certificate of posting is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted under certificate of posting therefore does so at his own risk.

The view taken by the Council has been confirmed in a decision by the *Rajasthan High Court in J.S. Bhati vs. The Council of the Institute of the Chartered Accountants of India* and another. (Pages 72-79 of Vol. V of Disciplinary Cases published by the Institute - Judgement delivered on 29th August, 1975). The following observations of the Court are relevant in this context:-

“Mere obtaining a certificate of posting in my opinion does not fulfill the requirements of clause (8) of Schedule I as the presumption under Section 114 of the Evidence Act that the letter in due course reached the addressee cannot replace that positive degree of proof of the delivery of the letter to the addressee which the letters of the law in this case require. The expression ‘in communication with’ when read in the light of the instructions contained in the booklet ‘Code of Conduct’ cannot be interpreted in any other manner but to mean that there should be positive evidence of the fact that the communication addressed to the outgoing auditor by the incoming auditor reached his hands. Certificate of posting of a letter cannot, in the circumstances, be taken as positive evidence of its delivery to the addressee.”

Members should therefore communicate with a retiring auditor in such a manner as to retain in their hands positive evidence of the delivery of the communication to the addressee. In the

opinion of the Council, communication by a letter sent "Registered Acknowledgement due" or by hand against a written acknowledgement would in the normal course provide such evidence.

The Council is of the opinion that it would be a healthy practice to communicate with the member who had done the work previously in every case where a Chartered Accountant is required to give a certificate or in respect of a verification of the books of account for special purpose as well as in cases where he is appointed as a Liquidator, Trustee, or Receiver and his predecessor was a Chartered Accountant.

As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to act jointly with the earlier auditor and to communicate with such earlier auditor.

It would also be a healthy practice if a tax auditor appointed for conducting special audit under the Income-tax Act, communicates with the member who has conducted the statutory audit.

It is desirable that a member, on receiving communication from the auditor who has been appointed in his place, should send a reply to him as soon as possible setting out in detail the reasons, which according to him had given rise to the change and other attendant circumstances but without disclosing any information as regards the affairs of the client which he is not competent to do.

The Council has taken the view that it is not obligatory for the auditor appointed to conduct a Special Audit under Section 233A of Companies Act, 1956 to communicate with the previous auditor who had conducted the regular audit for the period covered by the Special Audit.

The Council has also laid down the detailed guidelines on the subject as under:-

1. The requirement for communicating with the previous auditor being a Chartered Accountant in practice would apply to all types of audit viz., statutory audit, tax audit, internal audit, concurrent audit or any other kind of audit.
2. Various doubts have been raised by the members about the terms "audit", "previous auditor", "Certificate" and "report", normally while interpreting the aforesaid Clause (8). These terms need to be clarified.
3. As per para 2 of the Institute's publication viz. Standard on Auditing (SA) 200, *Overall Objectives of the Independent Auditor and Conduct of an Audit in Accordance with Standards on Auditing* an "audit" is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.
4. The term "previous auditor" means the immediately preceding auditor who held same or similar assignment comprising same/similar scope of work. For example, a Chartered Accountant in practice appointed for an assignment of physical verification of inventory of raw materials, spares, stores and finished goods, before acceptance of appointment,

III.346 Auditing Pronouncements

must communicate with the previous auditor being a Chartered Accountant in practice who was holding the appointment of physical verification of inventory of raw materials, stores, finished goods and fixed assets. The mandatory communication with the previous auditor being a Chartered Accountant is required even in a case where the previous auditor happens to be an auditor for a year other than the immediately preceding year.

5. As explained in para 2.2 of the Institute's publication viz., 'Guidance Note on Audit Reports and Certificates for Special Purposes', a "certificate" is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A "report", on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.
6. A communication is mandatorily required for all types of audit/report where the previous auditor is a Chartered Accountant. For certification, it would be healthy practice to communicate. In case of assignments done by other professionals not being Chartered Accountants, it would also be a healthy practice to communicate.
7. Although the mandatory requirement of communication with previous auditor being Chartered Accountant applies, in uniform manner, to audits of both government and non government entities, yet in the case of audit of government Companies/banks or their branches, if the appointment is made well in time to enable the obligation cast under this clause to be fulfilled, such obligation must be complied with before accepting the audit. However, in case the time schedule given for the assignment is such that there is no time to wait for the reply from the outgoing auditor, the incoming auditor may give a conditional acceptance of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause. In his acceptance letter, he should make clear to the client that his acceptance of appointment is subject to professional objections, if any, from the previous auditors and that he will decide about his final acceptance after taking into account the information received from the previous auditor.

APPENDIX IV
[PARA 9.8, 9.9, 9.10, 9.23]

Council Guidelines No.1-CA(7)/02/2008, dated 8th August,2008

GUIDELINES FOR THE MEMBERS OF ICAI

(Issued under the provisions of The Chartered Accountants Act, 1949)

Chapter I

Preliminary

1.0 Short title, commencement, etc.

- (a) These Guidelines have been issued by the Council of the Institute of Chartered Accountants of India under the provisions of The Chartered Accountants Act, 1949, as amended by The Chartered Accountants (Amendment) Act 2006, in supersession of the Notifications issued by the Council under erstwhile Clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.
- (b) These Guidelines be called the 'Council General Guidelines, 2008'.

1.1 Definitions.

1.1.1 For the purpose of these Guidelines:

- (a) 'Act' means the Chartered Accountants Act, 1949.
- (b) "Chartered accountant" means a person who is a member of the Institute.
- (c) "Council" means the Council of the Institute constituted under section 9 of the Act.
- (d) "Institute" means the Institute of Chartered Accountants of India constituted under the Act.

1.1.2 All other words and expressions used but not defined herein have the same meaning as assigned to them within the Chartered Accountants Act, 1949 and the Rules, Regulations and Guidelines made there under.

1.2 Applicability of the Guidelines

These guidelines shall be applicable to all the Members of the Institute whether in practice or not wherever the context so requires.

Chapter II

Conduct of a Member being an employee

2.0 A member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

Chapter III

Appointment of a Member as Cost auditor

3.0 A member of the Institute shall not accept:

- (i) The appointment as Cost auditor of a Company under Section 233B of the Companies Act, 1956 while he-
 - (a) is an auditor of the Company appointed under Section 224 of the Companies Act; or
 - (b) is an officer or employee of the Company; or
 - (c) is a partner, of any employee or officer of the Company; or
 - (d) is a partner or is in the employment of the Company's auditor appointed under Section 224 of the Companies Act, 1956; or
 - (e) is indebted to the Company for an amount exceeding one thousand rupees, or has given any guarantee or provided any security in connection with the indebtedness of any third person to the Company for an amount exceeding one thousand rupees;

OR

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

3.1 A member of the Institute in practice shall not accept the appointment as auditor of a Company under Section 224 of the Companies Act, 1956, while he is an employee of the cost auditor of the Company appointed under Section 233B of the Companies Act, 1956.

Chapter IV

Opinion on financial statements when there is substantial interest

4.0 A member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons who are his "relatives" within the meaning of Section 6 of the Companies Act, 1956 have, either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise.

Explanation: For this purpose and for the purpose of compliance of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, the expression "substantial

interest” shall have the same meaning as is assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988.

Chapter V

Maintenance of books of accounts

5.0 A member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his / its professional practice, proper books of account including the following:-

- (i) a Cash Book;
- (ii) a Ledger.

Chapter VI

Tax Audit assignments under Section 44 AB of the Income-tax Act, 1961

6.0 A member of the Institute in practice shall not accept, relating to an assessment year, more than the “specified number of tax audit assignments” under Section 44AB of the Income-tax Act, 1961.

Provided that in the case of a firm of Chartered Accountants in practice, the “specified number of tax audit assignments” shall be construed as the specified number of tax audit assignments for every partner of the firm.

Provided further that where any partner of the firm is also a partner of any other firm or firms of Chartered Accountants in practice, the number of tax audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the “specified number of tax audit assignments” in the aggregate.

Provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the “specified number of tax audit assignments” in the aggregate.

Provided also that the audits conducted under Section 44AD, 44AE and 44AF of the Income-tax Act, 1961 shall not be taken into account for the purpose of reckoning the “specified number of tax audit assignments”.

6.1 Explanation:

For the above purpose, “the specified number of tax audit assignments” means -

- (a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, 60 tax audit assignments, relating to an assessment year, whether in respect of corporate or non-corporate assesses.

III.350 Auditing Pronouncements

(b) in the case of firm of Chartered Accountants in practice, 60 tax audit assignments per partner in the firm, relating to an assessment year, whether in respect of corporate or non-corporate assesses.

6.1.1 In computing the “specified number of tax audit assignments” each year’s audit would be taken as a separate assignment.

6.1.2 In computing the “specified number of tax audit assignments”, the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

6.1.3 The audit of the head office and branch offices of a concern shall be regarded as one tax audit assignment.

6.1.4 The audit of one or more branches of the same concern by one Chartered Accountant in practice shall be construed as only one tax audit assignment.

6.1.5 A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the tax audit assignments of the firm.

6.1.6 A Chartered Accountant in practice shall maintain a record of the tax audit assignments accepted by him relating to each assessment year in the format as may be prescribed by the Council.

Chapter VII

Appointment of an Auditor in case of non-payment of undisputed fees

7.0 A member of the Institute in practice shall not accept the appointment as auditor of an entity in case the undisputed audit fee of another Chartered Accountant for carrying out the statutory audit under the Companies Act, 1956 or various other statutes has not been paid:

Provided that in the case of sick unit, the above prohibition of acceptance shall not apply.

7.1 Explanation 1:

For this purpose, the provision for audit fee in accounts signed by both - the auditee and the auditor shall be considered as “undisputed” audit fee.

7.2 Explanation 2:

For this purpose, “sick unit” shall mean where the net worth is negative.

Chapter VIII

Specified number of audit assignments

8.0 A member of the Institute in practice shall not hold at any time appointment of more than the “specified number of audit assignments” of Companies under Section 224 and/or Section 228 of the Companies Act, 1956.

Provided that in the case of a firm of Chartered Accountants in practice, the “specified number of audit assignments” shall be construed as the specific number of audit assignments for every partner of the firm.

Provided further that where any partner of the firm of Chartered Accountants in practice is also a partner of any other firm or firms of Chartered Accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the “specified number of audit assignments” in the aggregate.

Provided further where any partner of a firm or firms of Chartered Accountants in practice accepts one or more audit of Companies in his individual capacity, or in the name of his proprietary firm, the total number of such assignments which may be accepted by all firms in relation to such Chartered Accountant and by him shall not exceed the “specified number of audit assignments” in the aggregate.

8.1 Explanation:

For the above purpose, the “specified number of audit assignments” means –

- a. in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, thirty audit assignments whether in respect of private Companies or other Companies.
- b. in the case of Chartered Accountants in practice, thirty audit assignments per partner in the firm, whether in respect of private Companies or other Companies.

Provided that out of such “specified number of audit assignments, the number of audit assignments of public Companies each of which has a paid-up share capital of rupees twenty-five lakhs or more, shall not exceed ten.

8.2 In computing the “specified number of audit assignments”-

- a. the number of audit of such Companies, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.
- b. the audit of the head office and branch offices of a Company by one Chartered Accountant or firm of such Chartered Accountants in practice shall be regarded as one audit assignment.

III.352 Auditing Pronouncements

- c. the audit of one or more branches of the same Company by one Chartered Accountant in practice or by firm of Chartered Accountants in practice in which he is a partner shall be construed as one audit assignment only.
- d. the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

8.3 A Chartered Accountant in practice, whether in full-time or part-time employment elsewhere, shall not be counted for the purpose of determination of “specified number of audit of Companies” by firms of Chartered Accountants.

8.4 A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the audit assignments of the firm.

8.5 A Chartered Accountant in practice as well as firm of Chartered Accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of Chartered Accountants, or by any of the partners of the firm in his individual name or as a partner of any other firm, as far as possible, in the following format:

S. No	Name of the Company	Registration Number	Date of Appointment	Date of Acceptance	Date on which Form 23-B filed with the Registrar of Companies
1	2	3	4	5	6

Chapter IX

Appointment as Statutory auditor

9.0 A member of the Institute in practice shall not accept the appointment as statutory auditor of Public Sector Undertaking(s)/ Government Company(ies)/ Listed Company(ies) and other Public Company(ies) having turnover of Rs. 50 crores or more in a year where he accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

Provided that in case appointing authority(ies)/regulatory body(ies) specify(ies) more stringent condition(s)/ restriction(s), the same shall apply instead of the conditions/ restrictions specified under these Guidelines.

9.1 The above restrictions shall apply in respect of fees for other work(s) or service(s) or assignment(s) payable to the statutory auditors and their associate concern(s) put together.

9.2 For the above purpose,

- (i) the term “other work(s)” or “service(s)” or “assignment(s)” shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include: -
 - (a) audit under any other statute;
 - (b) certification work required to be done by the statutory auditors; and
 - (c) any representation before an authority;
- (ii) the term “associate concern” means any corporate body or partnership firm which renders the Management Consultancy and all other professional services permitted by the Council wherein the proprietor and/or partner(s) of the statutory auditor firm and/or their “relative(s)” is/are Director/s or partner/s and/or jointly or severally hold “substantial interest” in the said corporate body or partnership;
- (iii) the terms “relative” and “substantial interest” shall have the same meaning as are assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988.

9.3 In regard to taking up other work(s) or service(s) or assignment(s) of the undertaking/company referred to above, it shall be open to such associate concern or corporate body to render such work(s) or service(s) or assignment(s) so long as aggregate remuneration for such other work(s) or service(s) or assignment(s) payable to the statutory auditor/s together with fees payable to its associate concern(s) or corporate body(ies) do/does not exceed the aggregate of fee payable for carrying out the statutory audit.

Chapter X

Appointment of an auditor when he is indebted to a concern

10.0 A member of the Institute in practice or a partner of a firm in practice or a firm shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding Rs. 10,000/-

Chapter XI

Directions in case of unjustified removal of auditors

11.0 A member of the Institute in practice shall follow the direction given, by the Council or an appropriate Committee or on behalf of any of them, to him being the incoming auditor(s) not to accept the appointment as auditor(s), in the case of unjustified removal of the earlier auditor(s).

Chapter XII

Minimum Audit Fee in respect of Audit*

12.0 A member of the Institute in practice shall not, on behalf of the firm of chartered accountants in which he is a partner, accept or carry out any audit work involving receipt of audit fees (excluding reimbursement of expenses, if any) for such work of an amount less than what is specified hereunder:-

- (a) consisting of 5 or more partners but less than 10 partners with at least one partner holding a certificate of practice for five years or more; or
- (b) consisting of 10 or more partners with at least one partner holding a certificate of practice for five years or more.

		Practising firm having 5 or more partners but less than 10 partners	Practising firm having 10 or more partners
(i)	In cities with population of 3 million and above. (as per the last census)	Rs. 6000/-p.a.	Rs. 12000/-p.a.
(ii)	In cities/towns having population of less than 3 million. (as per the last census)	Rs. 3500/-p.a.	Rs. 8000/-p.a.

Provided that such restriction shall not apply in respect of the following: -

- (i) audit of accounts of charitable institutions clubs, provident funds, etc. where the appointment is honorary i.e. without any fees;
- (ii) statutory audit of branches of banks including regional rural banks;
- (iii) audit of newly formed concerns relating to two accounting years from the date of commencement of their operations;
- (iv) certification or audit under Income-tax Act or other attestation work carried out by the Statutory Auditor; and
- (v) Sales Tax Audit and VAT Audit.

* Chapter XII – 'Minimum Audit fee in respect of Audit' was repealed by the Council at its 306th meeting held on 7th & 8th June, 2011.

12.1 Explanation:

For the purpose of these Guidelines, the expression statutory auditor means and includes a chartered accountant appointed as an auditor under a Central/State or Provincial Act as well as an auditor appointed under any agreement.

The Council has clarified that for the above purpose the audit of Provident Fund Trust, Gratuity Fund etc. carried out by the statutory auditor are to be considered as separate and distinct audit so that the above restrictions are applicable to it.

Chapter XIII

Repeal and Saving

13.0 The Notifications as specified in the Schedule hereto, issued under erstwhile Clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 by the Council from time to time shall stand repealed from the date herein.

13.1 Notwithstanding such repeal:-

- (a) Anything done or any action taken or purported to have been done or taken, any enquiry or investigation commenced or show cause notice issued in respect of the said notifications shall be deemed to have been done or taken under the corresponding provisions of these guidelines.
- (b) Any application made to the Council or Director (Discipline) under the said Notifications and pending before the Director (Discipline), Board of Discipline, Disciplinary Committee and the Council shall be deemed to have been made under the corresponding provisions of these Guidelines.

SCHEDULE

NOTIFICATIONS ISSUED BY THE COUNCIL UNDER ERSTWHILE CLAUSE (ii) OF PART II OF THE SECOND SCHEDULE TO THE CHARTERED ACCOUNTANTS ACT, 1949.

1. No.1- CA(7)/65, dated 6th November, 1965.
2. No.1- CA (37)/70, Published in Part III Section 4 of the Gazette of India dated 30th May, 1970.
3. No.1- CA (39)/70, Published in Part III Section 4 of the Gazette of India dated 24th October, 1970.
4. No.1-CA (44)/71, Published in Part III Section 4 of the Gazette of India dated 20th March, 1971.
5. No.1- CA (153)/86, Published in Part III Section 4 of the Gazette of India dated 30th August, 1986.
6. No.1- CA (7)/3/88, Published in Part III Section 4 of the Gazette of India dated 4th February, 1989.

7. No.1- CA (7)/9/89, Published in Part III Section 4 of the Gazette of India dated 19th August, 1989 (Since quashed by the Supreme Court vide Order dated 16th May, 2007).
8. No.1- CA (7)/43/99, Published in Part III Section 4 of the Gazette of India dated 31st July, 1999.
9. No.1- CA (7)/46/99, Published in Part III Section 4 of the Gazette of India dated 13th November, 1999.
10. No.1- CA (7)/53/2001, Published in Part III Section 4 of the Gazette of India dated 12th May, 2001.
11. No.1- CA (7)/60/2002, Published in Part III Section 4 of the Gazette of India dated 23rd March, 2002.
12. No.1- CA (7)/63/2002, Published in Part III Section 4 of the Gazette of India dated 7th September, 2002.
13. No.1- CA (7)/67/2002, Published in Part III Section 4 of the Gazette of India dated 19th October, 2002.
14. No.1- CA (7)/75/2004, Published in Part III Section 4 of the Gazette of India dated 22nd May, 2004.

APPENDIX V

[PARA 9.18]

Relevant extracts from the Code of Ethics, 11th Edition, January 2009 pages 239- 243 (*In view of the fact that with effect from 01.04.2014.the Companies Act, 1956 has been replaced with Companies Act, 2013, the "Code of Ethics" issued by ICAI is under revision. The members may refer the revised "Code of Ethics" as and when published.*)

Clause (4): expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest;

If the opinion of auditors are to command respect and the confidence of the public, it is essential that it must be free of any interest which is likely to affect their independence. Since financial interest in the business can be a substantial interest and one of the important factors which may disturb independence, the existence of such an interest direct or indirect affects the opinion of the auditors. As per this clause, an auditor should not express his opinion on financial statements of any business or enterprise wherein he has a substantial interest. This is intended to assure the public as regards the faith and confidences that could be reposed on the independent opinion expressed by the auditors.

In this connection attention of members is also invited to Chapter IV of Council Guidelines No.

1-CA(7)/02/2008 dated 8th August, 2008. The said guidelines state that a member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons, who are his “relatives” within the meaning of AS-18, have either by themselves or in conjunction with such members, a substantial interest in the said business or enterprise. For the purpose of said guideline and aforesaid clause, the expression “substantial interest” shall have meaning as is assigned thereto, under Appendix (9) of the Chartered Accountants Regulations, 1988. (see **Appendix-‘F’**).

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

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

Member must take care to see that they do not land themselves in situations where there could be conflict of interest and duty. For example, where a Chartered Accountant is appointed the Liquidator of a Company, he should not qua a Chartered Accountant himself, audit the Statement of Accounts to be filed under Section 551(1) of the Companies Act, 1956. The audit in such circumstances should be done by a chartered Accountant other than the one who is the Liquidator of the Company.

In this connection, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law, e.g. Section 228(iv) of the Companies Act, 1956 and the Companies (Branch Audit Exemption) Rules, 1961 made thereunder. The Council has also decided that a Chartered Accountant should not by himself or in his firm name:-

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

The Council has, in this connection, issued the following guidelines:

Attention of the members is invited to the provisions of Clause (4) of Part I of the Second

III.358 Auditing Pronouncements

Schedule to the Chartered Accountants Act which provides that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest.

Many new areas of professional work have been added, e.g., Tax Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of banks and financial institutions, audit of stock exchange, brokers etc. The Council wishes to emphasize that the aforesaid requirement of Clause (4) are equally applicable while performing all types of attest functions by the members. Some of the situations which may arise in the applicability of Clause (4) are discussed below for the guidance of members:-

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

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

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

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

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

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

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

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

(i) Where a member is a director

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

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

In such cases for the reason as not to compromise with the independence of mind, the member may desist from undertaking the audit of financial statements and/or expression of opinion thereon. The meaning of the words “relative” and “substantial interest” shall be the same as are contained in the Resolution passed by the Council in pursuance to Regulation, 190A of Chartered Accountants Regulations, 1988 (see **Appendix-‘F’**).

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

The Council has clarified that the members are not permitted to write the books of account of their auditee clients.

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

A member should satisfy himself before accepting an appointment as an auditor of an entity that his appointment is in accordance with the statute governing the entity. In case the entity is constituted under a trust deed/instrument, the member should satisfy whether his appointment is valid according to the instrument constituting the entity and rules and regulations made thereunder. In case the appointment is to be authorised by the regulatory authorities such as in the case of cooperative societies, trusts etc. then the member must satisfy whether such regulatory authorities have authorised the managing committee of the society/trust for appointment of the auditors. In a case where any entity is being managed by a Managing Committee or Board of Trustees or Board of Governors by whatever name called he should ensure that his appointment is duly made by a resolution passed of such Managing Committee or Board of Trustees or Board of Governors. Even in case of partnership or sole proprietary concerns, the member must ensure that a letter of appointment/engagement is given by the firm/sole proprietor before he accepts the appointment/ engagement.

APPENDIX VI**[PARA 9.26]****FORM OF TAX AUDIT PARTICULARS TO BE FURNISHED BY MEMBERS/FIRM****Record of Tax Audit Assignments**

1. Name of the Member accepting the assignment
2. Membership No.
3. Financial year of audit acceptance
4. Name and Registration No. of the firm/ firms of which the member is a proprietor or partner.

Sl.No.	Name of the auditee	Assessment year of the auditee	Date of appointment	Date of acceptance	Name of the firm on whose behalf the member has accepted the assignment	Date of communication with the previous auditor (applicable)
1	2	3	4	5	6	7

APPENDIX VII**[PARA 9.27]**

Revised Minimum recommended scale of fees chargeable for the professional assignments done by Chartered Accountants - An announcement hosted by Committee for Capacity Building of CA Firms and Small and Medium Practitioners-Last updated on 18th July, 2014:

PARTICULARS		Rates	
		For Class A Cities	For Class B Cities
		Revised Minimum Recommended scale of Fees	Revised Minimum Recommended scale of Fees
I)	ADVISING ON DRAFTING OF DEEDS/AGREEMENTS		
(a)	i) Partnership Deed	Rs. 10,500/- &	Rs. 7,000/- &

			Above	Above
		ii) Partnership Deed (With consultation & Tax Advisory)	Rs. 15,000/- & Above	Rs. 10,000/- & Above
	(b)	Filing of Forms with Registrar of Firms	Rs. 4,500/- & Above Per Form	Rs. 3,000/- & Above Per Form
	(c)	Supplementary / Modification in Partnership Deed	Rs. 9,000/- & Above	Rs. 6,000/- & Above
II)		INCOME TAX		
	A.	Filing of Return of Income		
	I)	For Individuals/ HUFs etc.		
		(a) Filing of Return of Income with Salary/Other Sources/Share of Profit	Rs. 6,000/- & Above	Rs. 4,000/- & Above
		(b) Filing of Return of Income with detailed Capital Gain working		
		(i) Less than 10 Transactions (For Shares & Securities)	Rs. 9,000/- & Above	Rs. 6,000/- & Above
		(ii) More than 10 Transactions (For Shares & Securities)	Rs. 15,000/- & Above	Rs. 10,000/- & Above
		(c) Filing of Return of Income for Capital Gain on Immovable property	Rs. 30,000/- & Above	Rs. 20,000/- & Above
		(d) Filing of Return of Income with Preparation of Bank Summary, Capital A/c & Balance Sheet.	Rs. 10,500/- & Above	Rs. 7,000/- & Above
	II)	(a) Partnership Firms/Sole Proprietor with Advisory Services	Rs. 12,000/- & Above	Rs. 8,000/- & Above
		(b) Minor's I.T. Statement	Rs. 6,000/- & Above	Rs. 4,000/- & Above
		(c) Private Ltd. Company :		
		(i) Active	Rs. 22,500/- & Above	Rs. 15,000/- & Above
		(ii) Defunct	Rs. 10,500/- & Above	Rs. 7,000/- & Above
		(d) Public Ltd. Company		
		(i) Active	Rs. 60,000/- & Above	Rs. 40,000/- & Above
		(ii) Defunct	Rs. 22,500/- & Above	Rs. 15,000/- & Above

III.362 Auditing Pronouncements

			Above	Above
	B.	Filing of Forms Etc.	(Quarterly Fees)	(Quarterly Fees)
		(a) Filing of TDS/TCS Return (per Form)		
		(i) With 5 or less Entries	Rs. 3,000/- & Above	Rs. 2,000/- & Above
		(ii) With more than 5 Entries	Rs. 7,500/- & Above	Rs. 5,000/- & Above
		(b) Filing of Form No. 15-H/G (per Set)	Rs. 3,000/- & Above	Rs. 2,000/- & Above
		(c) Form No. 49-A/49-B	Rs. 3,000/- & Above	Rs. 2,000/- & Above
		(d) Any other Forms filed under the Income Tax Act	Rs. 3,000/- & Above	Rs. 2,000/- & Above
	C.	Certificate		
		Obtaining Certificate from Income Tax Department	Rs. 12,000/- & Above	Rs. 8,000/- & Above
	D.	Filing of Appeals Etc.		
		(a) First Appeal Preparation of Statement of Facts, Grounds of Appeal, Etc.	Rs. 30,000/- & Above	Rs. 20,000/- & Above
		(b) Second Appeal (Tribunal)	Rs. 60,000/- & Above	Rs. 40,000/- & Above
	E.	Assessments Etc.		
		(a) Attending Scrutiny Assessment/Appeal		
		(i) Corporate	See Note 1	See Note 1
		(ii) Non Corporate	Rs. 30,000/- & Above	Rs. 20,000/- & Above
		(b) Attending before Authorities	Rs. 9,000/- & Above Per Visit	Rs. 6,000/- & Above Per Visit
		(c) Attending for Rectifications/Refunds/Appeal effects Etc.	Rs. 6,000/- & Above Per Visit	Rs. 4,000/- & Above Per Visit
		(d) Income Tax Survey	Rs. 75,000/- & Above	Rs. 50,000/- & Above

		(e) T.D.S. Survey	Rs. 45,000/- & Above	Rs. 30,000/- & Above
		(f) Income Tax Search and Seizure	See Note 1	See Note 1
		(g) Any other Consultancy	See Note 1	See Note 1
III)		CHARITABLE TRUST		
	(a)	(i) Registration Under Local Act	Rs. 22,500/- & Above	Rs. 15,000/- & Above
		(ii) Societies Registration Act	Rs. 30,000/- & Above	Rs. 20,000/- & Above
	(b)	Registration Under Income Tax Act	Rs. 22,500/- & Above	Rs. 15,000/- & Above
	(c)	Exemption Certificate U/s 80G of Income Tax Act	Rs. 18,000/- & Above	Rs. 12,000/- & Above
	(d)	Filing Objection Memo/other Replies	Rs. 9,000/- & Above	Rs. 6,000/- & Above
	(e)	Filing of Change Report	Rs. 9,000/- & Above	Rs. 6,000/- & Above
	(f)	Filing of Annual Budget	Rs. 9,000/- & Above	Rs. 6,000/- & Above
	(g)	Attending before Charity Commissioner including for Attending Objections	Rs. 7,500/- & Above per visit	Rs. 5,000/- & Above per visit
	(h)	(i) F.C.R.A. Registration	Rs. 30,000/- & Above	Rs. 20,000/- & Above
		(ii) F.C.R.A. Certification	Rs. 7,500/- & Above	Rs. 5,000/- & Above
IV)		COMPANY LAW AND LLP WORK		
	(a)	Filing Application for Name Approval	Rs. 6,000/- & Above	Rs. 4,000/- & Above
	(b)	Incorporation of a Private Limited Company/LLP	Rs. 30,000/- & Above	Rs. 20,000/- & Above
	(c)	Incorporation of a Public Limited Company	Rs. 60,000/- & Above	Rs. 40,000/- & Above
	(d)	(i) Company's/LLP ROC Work, Preparation of Minutes, Statutory Register & Other Secretarial Work	See Note 1	See Note 1
		(ii) Certification (Per Certificate)	Rs. 9,000/- & Above	Rs. 6,000/- & Above
	(e)	Filing Annual Return Etc.	Rs. 9,000/- & Above	Rs. 6,000/- & Above

III.364 Auditing Pronouncements

			Above per Form	Above per Form
	(f)	Filing Other Forms Like : F-32, 18, 2 etc.	Rs. 3,000/- & Above per Form	Rs. 2,000/- & Above per Form
	(g)	Increase in Authorised Capital		
		Filing of F-5, F-23, preparation of Revised Memorandum of Association/Article of Association/LLP Agreement	Rs. 22,500/- & Above	Rs. 15,000/- & Above
	(h)	DPIN/DIN per Application	Rs. 3,000/- & Above	Rs. 2,000/- & Above
	(i)	Company Law Consultancy including Petition drafting	See Note 1	See Note 1
	(j)	Company Law representation including LLP before RD and CLB	See Note 1	See Note 1
	(k)	ROC Representation	See Note 1	See Note 1
V)		V.A.T./ PROFESSIONAL TAX		
	A.	Registration Work		
		(a) Registration Under V.A.T. & C.S.T. Corporate Non Corporate	See Note 1 Rs. 15,000/- & Above	See Note 1 Rs. 10,000/- & Above
		(b) Professional Tax Registration (PTR)	Rs. 6,000/- & Above	Rs. 4,000/- & Above
		(c) Professional Tax Enrollment (per Application)	Rs. 3,000/- & Above	Rs. 2,000/- & Above
	B.	Filing of Return (V.A.T.)		
		(a) Monthly Challans with Annual Return	Rs. 3,000 + (Per Month)	Rs. 2,000/- + (Per Month)
		(b) Quarterly Challans with Annual Return	Rs. 4,500 + (Per Quarter)	Rs. 3,000/- + (Per Quarter)
		(c) Six Monthly Challans with Annual Return	Rs. 6,000 + (Per 6 Months)	Rs. 4,000/- + (Per 6 Months)
		(d) Yearly Composition Return	Rs. 9,000/- & Above	Rs. 6,000/- & Above
	C.	Assessments/Appeals		
		(a) Attending V.A.T./Commercial	Rs. 15,000/- +	Rs. 10,000/- +

		Tax Assessments	7,500/- (Per Visit)	5,000/- (Per Visit)
		(b) Attending V.A.T./Commercial Tax Appeals	Rs. 15,000/- + 9,000/- (Per Visit)	Rs. 10,000/- + 6,000/- (Per Visit)
	D.	Filing of Appeal/Appeals Drafting		
		(a) First Appeal (AC/DC)	Rs. 15,000/- & Above	Rs. 10,000/- & Above
		(b) Second Appeal	Rs. 22,500/- & Above	Rs. 15,000/- & Above
	E.	Miscellaneous Work		
		(a) Professional Tax Returns & Assessment	Rs. 7,500/- & Above	Rs. 5,000/- & Above
		(b) Obtaining C/F/H Forms under V.A.T./Commercial Tax	(Per Application)	(Per Application)
		(i) First Time	Rs. 6,000/- & Above	Rs. 4,000/- & Above
		(ii) Renewal	Rs. 3,000/- & Above	Rs. 2,000/- & Above
VI)		AUDIT AND OTHER ASSIGNMENTS		
		Rate per day would depend on the complexity of the work and the number of days spent by each person		
		(i) Principal	Rs. 15,000/- & Above per day	Rs. 10,000/- & Above per day
		(ii) Qualified Assistants	Rs. 7,500/- & Above per day	Rs. 5,000/- & Above per day
		(iii) Semi Qualified Assistants	Rs. 3,000/- & Above per day	Rs. 2,000/- & Above per day
		(iv) Other Assistants	Rs. 1,500/- & Above per day	Rs. 1,000/- & Above per day
		Subject to minimum indicative Fees as under:		

III.366 Auditing Pronouncements

	(i) Tax Audit	Rs. 37,500/- & Above	Rs. 25,000/- & Above
	(ii) Company Audit		
	(a) Small Pvt. Ltd. Co. (Turnover up to Rs. 2 Crore)	Rs. 45,000/- & Above	Rs. 30,000/- & Above
	(b) Medium Size Pvt. Ltd. Co./ Public Ltd. Co.	Rs. 75,000/- & Above	Rs. 50,000/- & Above
	(c) Large Size Pvt. Ltd. Co./Public Ltd. Co.	See Note 1	See Note 1
	(iii) V.A.T. Audit	Rs. 22,500/- & Above	Rs. 15,000/- & Above
	(iv) Review of TDS Compliance	Rs. 22,500/- & Above	Rs. 15,000/- & Above
	(v) Transfer Pricing Audit	See Note 1	See Note 1
VII)	INVESTIGATION, MANAGEMENT SERVICES OR SPECIAL ASSIGNMENTS		
	Rate per day would depend on the complexity of the work and the number of days spent by each person		
	(a) Principal	Rs. 30,000/- & Above + per day charge	Rs. 20,000/- & Above + per day charge
	(b) Qualified Assistant	Rs. 15,000/- & Above + per day charge	Rs. 10,000/- & Above + per day charge
	(c) Semi Qualified Assistant	Rs. 7,500/- & Above + per day charge	Rs. 5,000/- & Above + per day charge
VIII)	CERIFICATION WORK		
	(a) Issuing Certificates under the Income Tax Act i.e. U/s 80IA/80IB/10 A/10B & other Certificates	See Note 1	See Note 1
	(b) Other Certificates		
	For LIC/Passport/Credit Card/Etc.	Rs. 7,500/- & Above	Rs. 5,000/- & Above
	(c) Other Attestation (True Copy)	Rs. 1,500/- per	Rs. 1,000/- per

			form	Form
	(d)	Net worth Certificate for person going abroad	Rs. 1,5000/- & Above	Rs. 10,000/- & Above
IX)	WEALTH TAX			
	(a)	Per statement	Rs. 15,000/- & Above	Rs. 10,000/- & Above
	(b)	Statement & Filing Return	Rs. 20,000/- & Above	Rs. 15,000/- & Above
X)	CONSULTATION & ARBITRATION			
		Rate per hour would depend on the complexity of the work and the number of hours agent by each person.		
	(a)	Principal	Rs. 30,000/- & Above(initial fees) + additional fees @ Rs. 7,500/- & Above per hour	Rs. 20,000/- & Above(initial fees) + additional fees @ Rs. 5,000/- & Above per hour
	(b)	Qualified Assistant	Rs. 5,300/- & Above per hour	Rs. 3,500/- & Above per hour
	(c)	Semi Qualified Assistant	Rs. 2,300/- & Above per hour	Rs. 1,500/- & Above per hour
XI)	NBFC/RBI MATTERS			
	(a)	NBFC Registration with RBI	See Note 1	See Note 1
	(b)	Other Returns	Rs. 15,000/- & Above	Rs. 10,000/- & Above
XII)	SERVICE TAX			
	(a)	Registration	Rs. 15,000/- & Above	Rs. 10,000/- & Above
	(b)	Registration with Consultation	See Note 1	See Note 1
	(c)	Tax Advisory & Consultation i.e. about value, taxability, classification etc.	See Note 1	See Note 1
	(d)	Monthly Challan with Half Yearly Return	Rs. 15,000/- & Above + (Rs.3,000/- Per	Rs. 10,000/- & Above + (Rs.2,000/- Per Month)

III.368 Auditing Pronouncements

			Month)	
	(e)	Quarterly Challan with Half Yearly Return	Rs. 15,000/- & Above + (Rs. 4,500/- Per Quarter)	Rs. 10,000/- & Above + (Rs.3,000/- Per Quarter)
	(f)	Adjudication	Rs. 45,000/- & Above	Rs. 30,000/- & Above
	(g)	Appeal & show cause notice drafting/ reply	Rs. 30,000/- & Above	Rs. 20,000/- & Above
XIII)	FEMA MATTERS			
	1	Filing Declaration with RBI in relation to transaction by NRIs/OCBs	Rs. 30,000/- & Above	Rs. 20,000/- & Above
	2	Obtaining Prior Permissions from RBI for Transaction with NRIs/OCBs	Rs. 45,000/- & Above	Rs. 30,000/- & Above
	3	Technical Collaboration:		
		Advising, obtaining RBI permission, drafting and preparing technical collaboration agreement and incidental matters	See Note 1	See Note 1
	4	Foreign Collaboration:		
		Advising, obtaining RBI permission, drafting and preparing technical collaboration agreement and incidental matters (incl. Shareholders Agreement)	See Note 1	See Note 1
	5	Advising on non Resident Taxation Matters including Double Tax Avoidance Agreements including FEMA	See Note 1	See Note 1
XIV)	PROJECT FINANCING			
	(a)	Preparation of CMA Data	See Note 1	See Note 1
	(b)	Services relating to Financial sector	See Note 1	See Note 1

Notes:

1) Fees to be charged depending on the complexity and the time spent on the particular assignment.

2) The above recommended minimum scale of fees is as recommended by the Committee for Capacity Building of CA Firms & Small and Medium Practitioners (CCBCAF&SMP) of ICAI and duly considered by the council.

3) The aforesaid table states recommendatory minimum scale of fees works out by taking into account average time required to complete such assignments. However, members are free to charge varying rates depending upon the nature and complexity of assignment and time involved in completing the same.

4) Office time spent in travelling & out-of-pocket expenses would be chargeable. The Committee issues for general information the above recommended scale of fees which it considers reasonable under present conditions. It will be appreciated that the actual fees charged in individual cases will be matter of agreement between the member and the client.

5) Service Tax should be collected separately wherever applicable.

6) The Committee also recommends that the bill for each service should be raised separately and immediately after the services are rendered.

7) "Class A Cities here includes Delhi, Mumbai, Calcutta, Chennai, Pune, Hyderabad, Bangalore and Ahmedabad.

Class B Cities includes all other cities not included in "Class A".

8) The amount charged will be based on the location of the service provider.

Please note the above mentioned rates are as per the data available on ICAI website at below link:

http://www.icaai.org/new_post.html?post_id=7252

APPENDIX VIII

[PARA 10.3 & 10.8]

I. Harmonised Criteria for Classification of Entities

(1) Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

- (i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

III.370 Auditing Pronouncements

- (ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
- (iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.
- (iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.
- (v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

- (i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds 1 crore but does not exceed rupees fifty crore in the immediately preceding accounting year.
- (ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.
- (iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

- (1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.
- (2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

(2) Criteria for classification of companies under the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

- (f) "Small and Medium Sized Company" (SMC) means, a company-
- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
 - (ii) which is not a bank, financial institution or an insurance company;
 - (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
 - (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

III.372 Auditing Pronouncements

- (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non-SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-
 - 1.1 the SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

“The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company.”
 - 1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.
 - 1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.
 - 1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.
 - 1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

“5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods.”

II Applicability of Accounting Standards to Companies

(I) Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

- AS 1 Disclosures of Accounting Policies
- AS 2 Valuation of Inventories
- AS 4 Contingencies and Events Occurring After the Balance Sheet Date
- AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
- AS 6 Depreciation Accounting
- AS 7 Construction Contracts (revised 2002)
- AS 9 Revenue Recognition
- AS 10 Accounting for Fixed Assets
- AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)
- AS 12 Accounting for Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 16 Borrowing Costs
- AS 18 Related Party Disclosures
- AS 22 Accounting for Taxes on Income
- AS 24 Discontinuing Operations
- AS 26 Intangible Assets

(II) Exemptions or Relaxations for SMCs as defined in the Notification

- (A) Accounting Standards not applicable to SMCs in their entirety:*

III.374 Auditing Pronouncements

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

(B) *Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs³:*

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) *Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:*

(i) Accounting Standard (AS)15, Employee Benefits (revised 2005)

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

³ AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

- (d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.
- (ii) AS 19, Leases
Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.
- (iii) AS 20, Earnings Per Share
Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.
- (iv) AS 28, Impairment of Assets
SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.
- (v) AS 29, Provisions, Contingent Liabilities and Contingent Assets
Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.
- (D) *AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.*

III. Applicability of Accounting Standards to Non-corporate Entities (As on 1.4.2008)

- (I) **Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)**
AS 1 Disclosures of Accounting Policies

III.376 Auditing Pronouncements

- AS 2 Valuation of Inventories
- AS 4 Contingencies and Events Occurring After the Balance Sheet Date
- AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
- AS 6 Depreciation Accounting
- AS 7 Construction Contracts (revised 2002)
- AS 9 Revenue Recognition
- AS 10 Accounting for Fixed Assets
- AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)
- AS 12 Accounting for Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 16 Borrowing Costs
- AS 22 Accounting for Taxes on Income
- AS 26 Intangible Assets

(II) Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

- AS 3 Cash Flow Statements
- AS 17 Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

- AS 3 Cash Flow Statements
- AS 17 Segment Reporting
- AS 18 Related Party Disclosures
- AS 24 Discontinuing Operations

- (C) *Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:*⁴
- (i) AS 21, Consolidated Financial Statements
 - (ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
 - (iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)
- (D) *Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):*
- (i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)
 - (1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:
 - (a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);
 - (b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;
 - (c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(I) of the Standard; and

⁴ AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

III.378 Auditing Pronouncements

- (d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.
- (2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:
 - (a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);
 - (b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;
 - (c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and
 - (d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.
- (ii) AS 19, Leases
Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non-corporate entities falling in Level II .
Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.
- (iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to non-corporate entities falling in Level II and Level III.

(E) *AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.*

APPENDIX IX

[PARA 11.11]

APPLICABILITY OF SA 700, FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS, TO FORMATS OF AUDITOR'S REPORTS PRESCRIBED UNDER VARIOUS LAWS AND/ OR REGULATIONS (22.08.2013)

1. The Council of ICAI, at its 326th meeting held from 27th to 29th July 2013 considered the issue relating to application of Standard on Auditing (SA) 700, Forming An Opinion And Reporting on Financial Statements to such cases where the format of the auditor's report is prescribed under the relevant law or the regulation thereunder and are per se not in line with the requirements of SA 700. The Council noted that in many cases such prescribed auditor's

III.380 Auditing Pronouncements

report were required to be filed online in a preset form and, hence, it was not possible for the auditors to make necessary changes in these reports to bring them in line with the SA 700. Similarly, many a times, even where the auditor's report were to be submitted in a physical form and not filed online, the concerned regulatory/ government agencies may not accept such audit reports which contained any changes made by the auditors to the prescribed formats to bring them in line with SA 700.

2. In view of the above, the Council decided that while the matter was being taken up by the Institute with the relevant regulatory authorities/ Government agencies, etc., to change the prescribed formats for bringing the same in line with the requirements of SA 700, the members may, in the situations described in paragraph 1 above, submit the auditor's report in the format/s prescribed under the relevant law or regulation until announcement of necessary change is made by the appropriate authority. In such cases the members would not be viewed as having not complied with the provisions of SA 700.

3. In this context, it may also be noted that paragraph A55 of the SA 200, Overall Objectives of the Independent Auditor and the Conduct of An Audit in Accordance With Standards on Auditing clearly states as follows:

"A55. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements....."

4. Further, paragraph 43 of SA 700 requires that if the auditor is required by any law or regulation to use a specific layout or wording of the auditor's report, the auditor shall refer to Standards on Auditing only if the auditor's report includes, at minimum, each of the elements as prescribed in the said paragraph.

5. On a perusal of a cross section of the formats of the auditor's report prescribed under various laws, specially, the Income-tax Act, 1961 and the Value Added Tax Acts of various States, it is clear that these prescribed formats do not contain all the elements of the auditor's report as required in paragraph 43 of SA 700. In the background of the difficulties mentioned in paragraph 1 above, it may also not be possible for the auditors to suitably modify the prescribed format. Accordingly, it would not per se be possible for the auditors to state in their audit reports that the audit has been carried out in accordance with the Standards on Auditing. However, the auditors would be required to carry out the audits in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India.

The same can also be downloaded from the link below:

http://www.icai.org/new_post.html?post_id=9835

APPENDIX X

[PARA 13.13]

Circular No.561, dated 22nd May, 1990

Subject: Tax audit under section 44AB of the Income-tax Act, 1961, in the case of companies having accounting year other than financial year - Regarding

1. The Board have received representations regarding difficulties faced in complying with the provisions of section 44AB of the Income-tax Act, 1961, in the case of companies which follow an accounting period other than financial year.
2. Section 3 of the Income-tax Act, *inter alia*, provides that with effect from 1st April, 1989, "previous year" for the purposes of that Act means financial year immediately preceding the assessment year. In spite of the introduction of a uniform previous year for purposes of income-tax, some companies may adopt an accounting period other than the financial year, say the calendar year, under the Companies Act for other purposes.
3. In such cases, a question has arisen as to whether, under section 44AB of the Income-tax Act, the tax auditor can audit and certify the accounts for the period for which accounts have been maintained under the Companies Act (i.e., in this case the calendar year) or whether the tax auditor will have to certify the accounts for the relevant financial year which is the uniform accounting year for tax purposes.
4. The Board have considered the matter and are of opinion that as the income of the previous year is chargeable to tax and, for the purposes of Income-tax Act, the previous year is the financial year, the tax auditor would have to carry out the audit under section 44AB in respect of the period covered by the previous year, i.e., the relevant financial year. The proviso to the aforesaid section 44AB, therefore, covers only the cases where the accounts are audited under any other law in respect of the financial year. Where the accounting year is different from the financial year, the proviso to section 44AB will not apply. Consequently, the tax auditors would have to carry out the tax audit in respect of the period covered by the relevant financial year and submit his report in Form 3CB as required in rule 6G(1)(b) of the Income-tax Rules.

Sd/-
Nishi Nair
Under Secretary to the Government of India.
[F.No.205/4/90-ITA-II]

APPENDIX XI
[PARA 18.1, 32.7]

Circular No.739 dated 25-3-1996

Whether for assessment years subsequent to assessment year 1996-97, no deduction under section 40(b)(v) will be admissible unless partnership deed either specifies amount of remuneration payable to each individual working partner or lays down manner of quantifying such remuneration

1. The Board have received representations seeking clarification regarding disallowance of remuneration paid to the working partners as provided under section 40(b)(v) of the Income-tax Act. In particular, the representations have referred to two types of clauses which are generally incorporated in the partnership deeds.

These are:

- (i) The partners have agreed that the remuneration to a working partner will be the amount of remuneration allowable under the provisions of section 40(b)(v) of the Income-tax Act; and
- (ii) The amount of remuneration to working partner will be as may be mutually agreed upon between partners at the end of the year.

It has been represented that the Assessing Officers are not allowing deduction on the basis of these and similar clauses in the course of scrutiny assessments for the reason that they neither specify the amount of remuneration to each individual nor lay down the manner of quantifying such remuneration.

2. The Board have considered the representations. Since the amended provisions of section 40(b) have been introduced only with effect from the assessment year 1993-94 and these may not have been understood correctly, the Board are of the view that a liberal approach may be taken for the initial years. It has been decided that for the assessment years 1993-94 to 1996-97 deduction for remuneration to a working partner may be allowed on the basis of the clauses of the type mentioned at 1(i) above.

3. In cases where neither the amount has been quantified nor even the limit of total remuneration has been specified but the same has been left to be determined by the partners at the end of the accounting period, in such cases payment of remuneration to partners cannot be allowed as deduction in the computation of firm's income.

4. It is clarified that for the assessment years subsequent to the assessment year 1996-97, no deduction under section 40(b)(v) will be admissible unless the partnership deed either

specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration.

APPENDIX XII

[PARA 39.11]

THE RELEVANT EXTRACTS OF THE MICRO, SMALL AND MEDIUM ENTERPRISES DEVELOPMENT ACT, 2006

“Appointed day” means the day following immediately after the expiry of the period of fifteen days from the day of acceptance or the day of deemed acceptance of any goods or any services by a buyer from a supplier.

“Day of acceptance” means the day of actual delivery of the goods or the rendering of service or where any objection is made in writing by the buyer regarding the acceptance of goods or services within 15 days from the day of delivery of goods or rendering of services, the day on which the objection is removed by the supplier.

“Day of deemed acceptance” means , where no objection is made in writing by the buyer regarding acceptance of goods or services within fifteen days from the day of deliver of the goods or rendering of services, the day of the actual delivery of goods or the rendering of services.

“Buyer” means who so ever buys any goods or receives any services from the supplier for a consideration.

“Supplier” means a micro or small enterprise, which has filed a memorandum with the authority referred to in section 7(1)(a).

“Micro Enterprise” means:

- (a) In case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries(Development and Regulation) Act, 1951 an enterprise, where the investment in plant and machinery does not exceed twenty five lakh rupees;
- (b) In case of enterprises engaged in providing or rendering services, an enterprise, where the investment in equipment does not exceed ten lakh rupees.

“Small enterprise” means:

- (a) In case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries (Development and Regulation) Act, 1951 an enterprise, where the investment in plant and machinery is more than twenty five lakh rupees but does not exceed five crore rupees;

III.384 Auditing Pronouncements

- (b) In case of enterprises engaged in providing or rendering services, an enterprise, where the investment in equipment is more than ten lakh rupees but does not exceed two crore rupees.

“Medium enterprise” means

- (a) In case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries(Development and Regulation) Act, 1951 an enterprise, where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees;
- (b) In case of enterprises engaged in providing or rendering services, an enterprise, where the investment in equipment is more than two crore rupees but does not exceed five crore rupees.

Appendix XIII

[Para 40.1]

Chart of persons specified in Section 40A(2)(b)- (Refer Paragraph 40.1)

Part-I

Individual	Firm	Association of persons	HUF	Company
<i>His relatives</i>	<i>Its partners</i>	<i>Its members</i>	<i>Its members</i>	<i>Its directors</i>
	Their relatives	Their relatives	Their relatives	Their relatives

Part-II

Where person having substantial interest in the business or profession of the assessee is			
Individual	Association of persons	HUF	Company
His relatives	Its members	Its members	Its directors
	Their relatives	Their relatives	Their relatives
			any other company carrying on business or profession in which the first mentioned company has substantial interest

Note: Where one or more of the persons falling in any of the above categories (i.e. individual

and his relatives, firm, its partners and their relatives, etc.) have substantial interest in the business or profession carried on by any person – that person is also covered under section 40A(2)(b).

PART III

Director	Partner	Member of AOP	Member of HUF
Companies in which he is a Director	Firms in which he is a partner	AOP of which he is a member	
All other Directors of such Companies	All other partners of such firms	All other members of such AOP	All other members of such HUF
Their relatives	Their relatives	Their relatives	Their relatives

Notes:

1. Relative is defined in section 2(41) as in relation to an individual including husband, wife, brother, sister or any lineal ascendant or descendent of that individual.
2. "Person having a substantial interest" is explained in section 40A as under:
 - i. In the case of company - the person concerned is, at any time, during the previous year the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than 20% of the voting power.
 - ii. In other cases - such person is at any time during the previous year, beneficially entitled to not less than 20% of the profits of such business or profession.

APPENDIX XIV

[PARA 48.1]

Circular No. 208, dated 15th November, 1976

F.No. 208/7/76-ITA-II

Section 69D of the Income-tax Act, 1961 - Clarification Regarding

Whether payment on or after April 1, 1977 of amount borrowed on hundi is to comply with the section regardless of whether hundi was executed prior to the said date or on or after that date

1. The Taxation Laws (Amendment) Act, 1975, has added a new section 69D in Income-tax Act, 1961, with effect from 1st April, 1977, which provides that if any amount is borrowed from any person on a hundi or any amount due on it is repaid to any person, otherwise than through an account-payee cheque drawn on a bank, the amount so borrowed or repaid shall be assessed as the income of the tax-payer borrowing or repaying the said amount, for the previous year in which the amount is borrowed or repaid. This will also apply to the amount of interest paid on the amount borrowed on hundies. This provision is applicable only in respect of hundies and does not cover other types of loans, such as, repayment of loan by employees to employers, repayment of loan to banks, co-operative societies etc.

2. The term "hundi" has not been defined in the Income-tax Act, 1961. In common commercial parlance, it denotes an indigenous instrument in vernacular language which can be used by the holder thereof to collect money due thereon without using the medium of currency. It may also be regarded as an indigenous form of a bill of exchange expressed in vernacular language which has been in use in the mercantile community in India for the purpose of collecting dues. There are numerous varieties of hundies, for example Darshani Hundi, Muddati Hundi, Shaha Jogi Hundi, Jokhmi Hundi, Nam Jog Hundi, Dhani Jog Hundi, Jawabi Hundi and Zickri chit. The characteristics of hundies differ according to the varieties of the same. The following characteristics are found in most of the hundies:

1. A hundi is payable to a specified person or order or negotiable without endorsement by the payee.
2. A holder is entitled to sue on a hundi without an endorsement in his favour.
3. A hundi accepted by the drawee could be negotiated without endorsement.
4. If a hundi is lost, the owner could claim a duplicate or triplicate from the drawer and present it to the drawee for payment. Interest can be charged where usage is established.

3. This provision will come into force with effect from 1st April, 1977. Accordingly, any payment on or after 1st April, 1977, in respect of an amount borrowed on a hundi will have to comply with the requirements of this provision regardless of whether the hundi was executed prior to the said date or on or after that date.

Circular No. 221, dated 6-6-1977

[F. No. 208/25/76-IT(A-II)],

Whether provisions of the section are applicable to darshani hundi transactions

1. Reference is invited to Board's Circular No. 208 [F. No. 208/7/76-IT(A-II)], dated 15-11-1976 [printed at Sl. No. 478] in which the provisions of section 69D were explained.
2. A "hundi" in common commercial parlance denotes an indigenous form of bill of exchange, by and large in vernacular language, which is being used by the mercantile

community in India. The hundis can be broadly classified as (i) darshani hundis (sight or demand hundis), and (ii) muddati hundis (usance hundis payable after a stipulated period of time mentioned therein). Darshani hundis are of different varieties, viz, (i) shahjog hundis, (ii) dhanijog hundis, (iii) namjog hundis, (iv) dekharanarjog hundis, (v) farmanijog hundis, and (vi) jokhmi hundis.

3. It has been represented to the Board that a darshani hundi created solely for the purpose of remittances of funds or financing inland trade or for operating accounts through indigenous banking channels does not involve borrowal of amounts and as such does not fall within the scope of section 69D. There are more than two parties in a darshani hundi. Normally four parties are involved in the case of a darshani hundi, viz, (i) the rakhya (the holder or purchaser), (ii) the drawer (an indigenous banker or a vyapari), (iii) the drawee (normally an indigenous banker but can also be a vyapari), and (iv) the payee. If the payee is also the rakhya, the parties will be three. Darshani hundi is payable at sight, i.e, immediately on presentation. A muddati (usance) hundi generally involving two parties, is payable after a stipulated period of time mentioned in the hundi.

4. The matter has been considered by the Board. We have been advised that *the provisions of section 69D are not applicable to darshani hundi transactions mentioned hereinafter :*

- 1.(a) A, who is the rakhya obtains on payment from B, the drawer, a hundi drawn on C, the drawee, in favour of D, the payee.
- (b) A, the rakhya having a running account or an overdraft account with B, obtains from him a hundi drawn on C, the drawee, in favour of D, the payee.
- 2.(a) A, a purchaser of goods from B, draws a hundi on C, the drawee, in favour of B or a third party D for the purpose of payment of the price of goods purchased or for settling the account.
- (b) For such purposes B can also draw a hundi on A either in his own favour or in favour of a third party D.
3. A has an account with an indigenous banker C, who has granted a credit facility to A and handed over a hundi book to him. A draws amounts through such hundis payable either to self, or bearer or third party. Such an arrangement arises out of the credit facility already granted and, therefore, no debtor creditor relationship has arisen between the parties because of the drawal of a hundi.

5. Normally, borrowal on hundi arises when a person gets money by execution of a hundi but in the instances cited above the hundi is given in the nature of a security and there is no borrowal on such hundis. Thus in cases of transactions referred to at (1), (2) and (3) of para 4, section 69D is not applicable. The settlement of account between any of the parties to such a darshani hundi can, thus, be otherwise than through an account payee cheque within the meaning of section 69D.

6. This circular covers darshani hundi transactions of the types referred to at (1), (2) and (3) of para 4 above. However, it could not be said that there could be no borrowal on darshani hundi. The transactions not of the type referred to above, on darshani hundis have to be examined with reference to the facts and circumstances of such cases so as to determine whether or not there is a borrowal on such hundis.

APPENDIX XV
[PARA 13.9 & 71.3]

**RECOMMENDED FORM OF FINANCIAL STATEMENTS
FOR NON-CORPORATE ENTITIES**

**FORM OF BALANCE SHEET
(FOR NON CORPORATE MANUFACTURING ENTITIES)**

NAME OF ENTITY

BALANCE SHEET AS AT

<i>Figures for Previous year</i>	<i>Capital and Liabilities</i>	<i>Figures for Current year</i>	<i>Figures for Previous year</i>	<i>Properties and Assets</i>	<i>Figures for Current year</i>
	I. CAPITAL			I. FIXED ASSETS	
	(In case of partnership, these particulars to be given separately for each partner and if possible the fixed capital accounts may be segregated from the current accounts) as at the beginning of the year.			1. Under each head the original cost, the additions thereto, the deductions therefrom during the year and the total depreciation written off or provided upto the end of the year to be stated.	
	Add/Deduct Net Profit/Net Loss during the year			2. Where the assets have been revalued, the revalued figures to be shown. Each balance sheet for the first five years subsequent to the date of revaluation to state the amount of revaluation.	
	Interest on capital				
	Drawings				
	Any other items (give details)				
	II. RESERVES				
	(Give details under each				

head)

1. Capital reserves (if any)
2. Other Reserves (including restrained profits to the extent not already added to the capital, give details)
3. Sinking Funds (if any)

III. LOANS AND BORROWINGS

1. Interest accrued and due on each category to be shown separately.
2. In the case of secured loans the nature of security to be specified.
3. Amounts due for repayments within one year from the balance sheet date to be shown separately.
4. Loan from partners, relatives of the proprietors or partners to be shown separately,

A. CURRENT LIABILITIES

1. Sundry creditors for goods supplied
2. Sundry creditors (Others)
3. Advances / Progress Payments from customers /deposits from dealers, selling agents etc.
4. Interest and other charges accrued but not due for payment.

3. Distinguishing as far as possible between expenditure upon:

- a) Goodwill
- b) Land
- c) Buildings
- d) Leaseholds
- e) Railway sidings
- f) Plant and Machinery
- g) Furniture & Fittings
- h) Development of property
- i) Patents, Trademarks and designs
- j) Livestock
- k) Vehicles etc.
 1. Cost
 2. Less:

depreciation

II. ADVANCES AND DEPOSITS ON CAPITAL ACCOUNT

III. INVESTMENTS

(attach details of investment showing in each case nature of investment and mode of valuation e.g. cost or market value)

1. Investment in shares, debentures or bonds

5. Bills Payable
6. Statutory liabilities (Overdue amounts to be shown separately)
7. Other current liabilities and provisions (Major items to be shown separately).

B. PROVISIONS :

1. For taxation
Less advance tax paid
2. For Provident Fund
3. For Contingencies
4. Other provisions.
(A foot note to the balance sheet may be added to show separately)
1. Claims against the entity not acknowledged as debts.
2. Uncalled liability on shares partly paid
3. Estimated amount of contracts remaining to be executed to capital account and not provided for
4. Contingent liability for bills discounted.
5. Other money for which the entity is contingently liable (give details)
6. Aggregate amount of arrears of depreciation, if any.

(Note: Investments in concern wherein proprietor, partner or their relative are interested to be shown separately)

2. Immovable properties
3. Investments in the capital of partnership firms
4. Other investments.

IV. LOANS

1. The nature of security (if any) and amount of each type of loan to be specified.
2. Amounts due within one year to be shown separately.
3. Loans to proprietors, partners or associated concern (to be shown separately)
4. Loans considered bad or doubtful to be shown separately.
Less: provision for bad and Doubtful loans.

**V. CURRENT ASSETS
A-INVENTORIES)**

(The mode of valuation to be shown separately)

1. Raw materials (including stores and other items used in the process of manufacture)
2. Work in process.

3. Finished goods.
4. Consumable stores and spare parts.
5. Loose Tools.
6. Others

B. RECEIVABLES

1. Debts due and outstanding for a period exceeding six months (to be shown separately).
2. Instalments of deferred receivables due within one year to be shown separately.
3. Debts considered bad or doubtful to be shown separately.
4. Amount due from proprietors, partners or associated concerns to be shown separately.
 - i) On account of sales on deferred payments basis.
 - ii) On account of exports
 - iii) Others
- iv) Total receivables
- v) *Less: provision for bad and doubtful debts.*

C. BILLS OF EXCHANGE

(Same information to be given as for 'Receivables')

D. ADVANCE ON CURRENT ACCOUNT

(Same information to be given as for loans).

1. Advance to suppliers of merchandise supplies and sundries etc. and stores /spares/consumables.

2. Advance payment of taxes (in excess of tax payable)

3. Pre-paid expenses.

4. Others

E. CASH AND BANK BALANCES

1. Fixed deposit account

2. Current and savings account

3. Cash on hand

VI. MISCELLANEOUS EXPENDITURE

To the extent not written off or adjusted (specify the nature and amount of each item).

VII. ACCUMULATED

Losses: if any

i) before depreciation

ii) depreciation.

TOTAL RUPEES

TOTAL RUPEES

Notes on Balance Sheet

1. In case of partnership firms, state whether it is registered with registrar of firms, registration number, date of registration and the State in which it is registered.
2. Unless otherwise indicated, the terms used herein have the same meaning as they have in Schedule VI to the Companies Act, 1956.

**PRO FORMA OF PROFIT AND LOSS ACCOUNT
FOR A NON-CORPORATE MANUFACTURING ENTITY**

Name of the entity _____

Profit and Loss Account for the year ending _____ (000's omitted)

	Previous Year (actuals)	This Year
1. Sales		
(Income from services may be shown separately)		
2. Less: Excise Duty		
3. Net Sales		
(Item No.1 minus Item No.2)		
4. Add/Deduct/Increase /Decrease in Finished Goods		
Closing Stock		
Less: Opening Stock		
5. Cost of Production		
(a) Rawmaterial consumption.		
Add: Purchases		
Less: Closing Stock		
(b) Stores and spare consumption		
(c) Salaries and wages		
(d) Other manufacturing expenses, excluding depreciation		
Sub-total		
<i>Add:</i> Opening stocks-in-process		
<i>Deduct:</i> Closing stock-in-process		
Cost of production		
Gross profit/loss (Item No.3 minus Item No.4)		

III.394 Auditing Pronouncements

6. Sales and administrative expenses
7. Interest and other overheads
8. Other income/expenses Net (+)
9. Profit /loss before depreciation and tax
(Item No.5 minus item No.(6 + 7))
10. Depreciation
11. Profit after depreciation
12. Taxation
13. Profit after tax

Note:

1. Any item of expenditure which forms a significant proportion, say 5% or more of the total sales or has special significance otherwise, should be shown separately under appropriate heads for example (i) salary (ii) commission (iii) perquisites and money value thereof.
2. If audited accounts for the previous year are not available, the fact should be stated.

APPENDIX XVI

[PARA 13.9 & 71.3]

RECOMMENDED FORM OF FINANCIAL STATEMENTS FOR NON-CORPORATE TRADING ENTITIES

NAME OF ENTITY

BALANCE SHEET AS AT

<i>Figures for Previous year</i>	<i>Capital and Liabilities</i>	<i>Figures for Current year</i>	<i>Figures for Previous year</i>	<i>Properties and Assets</i>	<i>Figures for Current year</i>
	I. CAPITAL			I. FIXED ASSETS	
	(In case of partnership, these particulars to be given separately for each partner and if possible the fixed			1. Under each head the original cost, the additions thereto, the deductions therefrom	

capital accounts may be segregated from the current accounts) as at the beginning of the year.

Add/Deduct Net Profit/Net Loss during the year

Interest on capital

Drawings

Any other items (give details)

II. RESERVES

(Give details under each head)

1. Capital reserves (if any)
2. Other Reserves (including restrained profits to the extent not already added to the capital, give details)
3. Sinking Funds (if any)

III. LOANS AND BORROWINGS

1. Interest accrued and due on each category to be shown separately.
2. In the case of secured loans the nature of security to be specified.
3. Amounts due for repayments within one year from the balance sheet date to be shown separately.
4. Loan from partners, relatives of the proprietors or partners to be shown separately,

during the year and the total depreciation written off or provided upto the end of the year to be stated.

2. Where the assets have been revalued, the revalued figures to be shown. Each balance sheet for the first five years subsequent to the date of revaluation to state the amount of revaluation.

3. Distinguishing as far as possible between expenditure upon:

- a) Goodwill
 - b) Land
 - c) Buildings
 - d) Leaseholds
 - e) Railway sidings
 - f) Plant and Machinery
 - g) Furniture & Fittings
 - h) Development of property
 - i) Patents, Trademarks and designs
 - j) Livestock
 - k) Vehicles etc.
1. Cost
 2. Less: depreciation

- a) Loans from financial institutions.
- b) Loans and borrowings from banks (Specify the name of the bank, the relevant amount and the nature of the borrowing e.g. cash credit, term-loans, overdraft, packing credit etc. (separately)
- c) Fixed deposits (from public and others)
- d) Other (Give details)

IV. CURRENT LIABILITIES AND PROVISIONS

(Amounts due for payment beyond one year from the date of the balance sheet (to be shown separately)

A. CURRENT LIABILITIES

- 1. Sundry creditors for goods supplied
- 2. Sundry creditors (Others)
- 3. Advances / Progress Payments from customers/ deposits from dealers, selling agents etc.
- 4. Interest and other charges accrued but not due for payment.
- 5. Bills Payable
- 6. Statutory liabilities

(Overdue amounts to be shown separately)

- 7. Other current liabilities and provisions (Major items

II. ADVANCES AND DEPOSITS ON CAPITAL ACCOUNT

III. INVESTMENTS

(attach details of investment showing in each case nature of investment and mode of valuation e.g. cost or market value)

- 1. Investment in shares, debentures or bonds (Note: Investments in concern wherein proprietor, partner or their relative are interested to be shown separately)
- 2. Immovable properties
- 3. Investments in the capital of partnership firms
- 4. Other investments.

IV. LOANS

- 1. The nature, security (if any) and amount of each type of loan to be specified.
- 2. Amounts due within one year to be shown separately.
- 3. Loans to proprietors, partners or associated concern (to be shown separately)
- 4. Loans considered bad or doubtful to be stated

to be shown separately).

B. PROVISIONS :

1. For taxation

Less advance tax paid

2. For Provident Fund
3. For Contingencies
4. Other provisions.

(A foot note to the balance sheet may be added to show separately)

1. Claims against the entity not acknowledged as debts.
2. Uncalled liability on shares partly paid
3. Estimated amount of contracts remaining to be executed to capital account and not provided for
4. Contingent liability for bills discounted.
5. Other money for which the entity is contingently liable (give details)
6. Aggregate amount of arrears of depreciation, if any.

separately.

Less: provision for bad and Doubtful loans.

**V. CURRENT ASSETS
A-INVENTORIES**

(The mode of valuation to be shown separately)

1. Stock in Trade
2. Supplies and sundries (If the trading organization is also involved in any processing activity ties other categories of inventories, e.g., raw material, and work-in-progress, should be separately disclosed.

B. RECEIVABLES

1. Debts due and outstanding for a period exceeding six months (to be shown separately).
2. Instalments of deferred receivables due within one year to be shown separately.
3. Debts considered bad

or doubtful to be shown separately.

4. Amount due from proprietors, partners or associated concerns to be shown separately.

i) On account of sales on deferred payments basis.

ii) On account of exports

iii) Others

iv) Total receivables

v) *Less:* provision for bad and doubtful debts.

C. BILLS OF EXCHANGE

(Same information to be given as for 'Receivables')

D. ADVANCE ON CURRENT ACCOUNT

(Same information to be given as for loans).

1. rawmaterials and stores/
spares/consumable.

2. Advance payment of taxes (in excess of tax payable)

3. Pre-paid expenses.

4. Others

E. CASH AND BANK BALANCES

1. Fixed deposit account

2. Current and savings account

3. Cash on hand

VI. MISCELLANEOUS EXPENDITURE

To the extent not written off or adjusted (specify the nature and amount of each item).

VII. ACCUMULATED

Losses: if any

i) before depreciation

ii) depreciation

TOTAL RUPEES

TOTAL RUPEES

Notes on Balance Sheet

1. In case of partnership firms, state whether it is registered with registrar of firms, registration number, date of registration and the State in which it is registered.
2. Unless otherwise indicated, the terms used herein have the same meaning as they have in Schedule VI to the Companies Act, 1956.

PROFORMA OF PROFIT AND LOSS ACCOUNT FOR A TRADING ENTITY

Name of the entity _____

Profit and Loss Account for the year ending _____

	<i>Last Year</i> Rs.	<i>This Year</i> Rs.
1. Sales (Net of Sales Tax) (Income from services may be shown separately)		
2. Cost of goods sold		
a) Opening Stock		
Add: Purchases (Less returns)		

III.400 Auditing Pronouncements

- Less: Closing Stock
- b) Other direct expenses (if any)
3. Gross Profit (1 - 2)
 4. Sales and administrative expenses
 5. Other income/expenses* Net
 6. Interest
 7. Profit before depreciation and tax
[Item 3 minus item (4 + 5 + 6)]
 8. Depreciation
 9. Taxation (for example for registered firms)**
 10. Profit after depreciation & taxation
item 7 minus item (8 + 9)
-

Note:

- * Any item of expenditure which forms a significant proportion, say 5% or more of the total sales or has special significance otherwise, should be shown separately under appropriate heads for example (i) salary (ii) commission (iii) perquisites and money value thereof.
- ** Registered firms are subject to tax, before the profit is apportioned amongst partners.

APPENDIX XVII

FORM NO.3CA

[See rule 6G(1)(a)]

**Audit report under section 44AB of the Income-tax Act, 1961,
in a case where the accounts of the business or profession of a person have been
audited under any other law**

*I / we report that the statutory audit of M/s. _____ (Name and address of the assessee with Permanent Account Number) was conducted by *me / us / M/s. _____ in pursuance of the _____ Act, and*I/we annex hereto a copy of *my / our / their audit report dated _____ along with a copy of each of :-

- (a) the audited *profit and loss account / income and expenditure account for the period beginning from -----to ending on -----.

- (b) the audited balance sheet as at, _____; and
 - (c) documents declared by the said Act to be part of, or annexed to, the *profit and loss account / income and expenditure account and balance sheet.
2. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No. 3CD.
3. In *my / our opinion and to the best of *my / our information and according to examination of books of account including other relevant documents and explanations given to *me / us, the particulars given in the said Form No.3 CD are true and correct subject to the following observations/qualifications, if any:
- a.
 - b.
 - c.

.....
 **(Signature and stamp/Seal of the signatory)

Place : _____ Name of the signatory

Date : _____ Full address

Notes :

1. * Delete whichever is not applicable
2. **This report has to be signed by a person eligible to sign the report as per the provisions of section 44AB of the Income Tax Act, 1961.
3. Where any of the requirements in this Form is answered in the negative or with qualification, give reasons therefore.
4. The person who signs this audit report shall indicate reference of his membership number / certificate of practice / authority under which he is entitled to sign this report.

FORM NO.3CB

[See rule 6G(1)(b)]

Audit report under section 44AB of the Income-tax Act, 1961, in the case of a person referred to in clause (b) of sub-rule (1) of rule 6G

1. *I / we have examined the balance sheet as on, _____, and the *profit and loss account / income and expenditure account for the period beginning from -----to ending on -- -----, attached herewith, of _____(Name), _____(Address), _____(Permanent Account Number).

III.402 Auditing Pronouncements

2. *I / we certify that the balance sheet and the *profit and loss / income and expenditure account are in agreement with the books of account maintained at the head office at _____ and ** _____ branches.

3.(a) *I / we report the following observations / comments / discrepancies / inconsistencies; if any:

(b) Subject to above, -

(A) *I / we have obtained all the information and explanations which, to the best of *my / our knowledge and belief, were necessary for the purpose of the audit.

(B) In *my / our opinion, proper books of account have been kept by the head office and branches of the assessee so far as appears from *my / our examination of the books.

(C) In *my / our opinion and to the best of *my / our information and according to the explanations given to *me / us, the said accounts, read with notes thereon, if any, give a true and fair view :-

(i) in the case of the balance sheet, of the state of the affairs of the assessee as at 31st March, ;and

(ii) in the case of the *profit and loss account / income and expenditure account of the *profit / loss or *surplus / deficit of the assessee for the year ended on that date.

4. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No.3CD.

5. In *my/our opinion and to the best of *my / our information and according to explanations given to *me / us, the particulars given in the said Form No.3 CD are true and correct subject to following observations/qualifications, if any:

- a.
- b.
- c.

.....
*** (Signature and stamp/seal of the signatory)

Place : _____ Name of the signatory

Date : _____ Full address

Notes :

1. *Delete whichever is not applicable.
2. **Mention the total number of branches.

3. ***This report has to be signed by person eligible to sign the report as per the provisions of section 44AB of the Income Tax Act, 1961.
4. The person, who signs this audit report, shall indicate reference of his membership number / certificate of practice number / authority under which he is entitled to sign this report.

FORM NO.3CD

[See rule 6G(2)]

**Statement of particulars required to be furnished under
section 44AB of the Income-tax Act, 1961**

PART – A

1. Name of the assessee : _____
2. Address : _____
3. Permanent Account Number : _____
4. Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty, etc. If yes, please furnish the registration number or any other identification number allotted for the same
: _____
5. Status : _____
6. Previous year : from _____ to _____
7. Assessment year : _____
8. Indicate the relevant clause of section 44AB under which the audit has been Conducted
: _____

PART - B

- 9.(a) If firm or association of persons, indicate names of partners/members and their profit sharing ratios.
- (b) If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change
- 10.(a) Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession)

III.404 Auditing Pronouncements

(b) If there is any change in the nature of business or profession, the particulars of such change.

11.(a) Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.

(b) List of books of account maintained and the address at which the books of accounts are kept.

(In case books of account are maintained in a computer system, mention the books of account generated by such computer system. If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.)

(c) List of books of account and nature of relevant documents examined.

12. Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant section (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, Chapter XII-G, First Schedule or any other relevant section.)

13.(a) Method of accounting employed in the previous year

(b) Whether there had been any change in the method of accounting employed vis-a-vis the method employed in the immediately preceding previous year.

(c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)

(d) Details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.

14.(a) Method of valuation of closing stock employed in the previous year.

(b) In case of deviation from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish:

Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)

15. Give the following particulars of the capital asset converted into stock-in trade: -

(a) Description of capital asset;

(b) Date of acquisition;

(c) Cost of acquisition;

- (d) Amount at which the asset is converted into stock-in-trade.
16. Amounts not credited to the profit and loss account, being, -
- (a) the items falling within the scope of section 28;
- (b) the proforma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax where such credits, drawbacks or refunds are admitted as due by the authorities concerned;
- (c) escalation claims accepted during the previous year;
- (d) any other item of income;
- (e) capital receipt, if any.
17. Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, please furnish:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

18. Particulars of depreciation allowable as per the Income Tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form :-
- (a) Description of asset/block of assets.
- (b) Rate of depreciation.
- (c) Actual cost of written down value, as the case may be.
- (d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –
- (i) Central Value Added Tax credits claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,
- (ii) change in rate of exchange of currency, and
- (iii) subsidy or grant or reimbursement, by whatever name called.
- (e) Depreciation allowable.
- (f) Written down value at the end of the year

III.406 Auditing Pronouncements

19. Amounts admissible under sections:

Section	Amount debited to profit and loss account	Amounts admissible as per the provisions of the Income Tax Act, 1961 and also fulfils the conditions, if any specified under the the conditions, if any specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules,1962 or any other guidelines, circular, etc., issued in this behalf.
32AC		
33AB		
33ABA		
35(1)(i)		
35(1)(ii)		
35(1)(ia)		
35(1)(iii)		
35(1)(iv)		
35(2AA)		
35(2AB)		
35ABB		
35AC		
35AD		
35CCA		
35CCB		
35CCC		
35CCD		
35D		
35DD		
35DDA		
35E		

20.(a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)]

(b) Details of contributions received from employees for various funds as referred to in section 36(1)(va):

Serial number	Nature of fund	Sum received from employees	Due date for payment	The actual amount paid	The actual date of payment to the concerned authorities

21.(a) Please furnish the details of amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc

Nature	Serial number	Particulars	Amount in Rs.
Capital expenditure			
Personal expenditure			
Advertisement expenditure in any souvenir, brochure, tract, pamphlet or the like published by a political party			
Expenditure incurred at clubs being entrance fees and subscriptions			
Expenditure incurred at clubs being cost for club services and facilities used.			
Expenditure by way of penalty or fine for violation of any law for the time being force			

III.408 Auditing Pronouncements

Expenditure by way of any other penalty or fine not covered above			
Expenditure incurred for any purpose which is an offence or which is prohibited by law			

- (b) Amounts inadmissible under section 40(a):-
- (i) as payment to non-resident referred to in sub-clause (i)
- (A) Details of payment on which tax is not deducted:
- (I) date of payment
- (II) amount of payment
- (III) nature of payment
- (IV) name and address of the payee
- (B) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)
- (I) date of payment
- (II) amount of payment
- (III) nature of payment
- (IV) name and address of the payee
- (V) amount of tax deducted
- (ii) as payment referred to in sub-clause (ia)
- (A) Details of payment on which tax is not deducted:
- (I) date of payment
- (II) amount of payment
- (III) nature of payment
- (IV) name and address of the payee
- (B) Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub-section (1) of section 139.
- (I) date of payment

- (II) amount of payment
- (III) nature of payment
- (IV) name and address of the payer
- (V) amount of tax deducted
- (VI) amount out of (V) deposited, if any
- (iii) under sub-clause (ic) [Wherever applicable]
- (iv) under sub-clause (iia)
- (v) under sub-clause (iib)
- (vi) under sub-clause (iii)
 - (A) date of payment
 - (B) amount of payment
 - (C) name and address of the payee
- (vii) under sub-clause (iv)
- (viii) under sub-clause (v)
- (c) Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;
- (d) Disallowance/deemed income under section 40A(3):
 - (A) On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:

Serial number	Date of payment	Nature of payment	Amount	Name and Permanent Account Number of the payee, if available

- (B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);

Serial number	Date of payment	Nature of payment	Amount	Name and Permanent Account Number of the payee, if available

III.410 Auditing Pronouncements

- (e) provision for payment of gratuity not allowable under section 40A(7);
 - (f) any sum paid by the assessee as an employer not allowable under section 40A(9);
 - (g) particulars of any liability of a contingent nature;
 - (h) amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;
 - (i) amount inadmissible under the proviso to section 36(1)(iii).
22. Amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.
23. Particulars of payments made to persons specified under section 40A(2)(b).
24. Amounts deemed to be profits and gains under section 32AC or 33AB or 33ABA or 33AC.
25. Any amount of profit chargeable to tax under section 41 and computation thereof.
26. In respect of any sum referred to in clause (a),(b), (c), (d), (e) or (f) of section 43B, the liability for which:-
- (A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was
 - (a) paid during the previous year;
 - (b) not paid during the previous year;
 - (B) was incurred in the previous year and was
 - (a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);
 - (b) not paid on or before the aforesaid date.
- (State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost, etc., is passed through the profit and loss account.)
- 27.(a) Amount of Central Value Added Tax credits availed of or utilised during the previous year and its treatment in the profit and loss account and treatment of outstanding Central Value Added Tax credits in the accounts.
- (b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account.
28. Whether during the previous year the assessee has received any property, being share of a company not being a company in which the public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viiia), if yes, please furnish the details of the same.

29. Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same.

30. Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. [Section 69D]

31.*(a) Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year :-

- (i) name, address and Permanent Account Number (if available with the assessee) of the lender or depositor;
- (ii) amount of loan or deposit taken or accepted;
- (iii) whether the loan or deposit was squared up during the previous year;
- (iv) maximum amount outstanding in the account at any time during the previous year;
- (v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

*(These particulars needs not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)

(b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year:-

- (i) name, address and Permanent Account Number (if available with the assessee) of the payee;
- (ii) amount of the repayment;
- (iii) maximum amount outstanding in the account at any time during the previous year;
- (iv) whether the repayment was made otherwise than by account payee cheque or account payee bank draft.

(c) Whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents

(The particulars (i) to (iv) at (b) and comment at (c) above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act)

32.(a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available :

III.412 Auditing Pronouncements

Serial Number	Assessment Year	Nature of loss allowance (in rupees)	Amount as returned (in rupees)	Amounts as assessed (give reference to relevant order)	Remarks

(b) Whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.

(c) Whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, If yes, please furnish the details of the same.

(d) whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same.

(e) In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year.

33. Section-wise details of deductions, if any, admissible under Chapter VIA or Chapter III (Section 10A, Section 10AA).

Section under which deduction is claimed	Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules, 1962 or any other guidelines, circular, etc, issued in this behalf.

34.(a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:

Tax deduction and collection Account Number (TAN)	Section	Nature of payment	Total amount of payment or receipt of the nature specified in column (3)	Total amount on which tax was required to be deducted or collected out of (4)	Total amount on which tax was deducted or collected at specified rate out of (5)	Amount of tax deducted or collected out of (6)	Total amount on which tax was deducted or collected at less than specified rate out of (7)	Amount of tax deducted or collected on (8)	Amount of tax deducted or collected not deposited to the credit of the Central Government out of (6) and (8)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

(b) whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details:

Tax deduction and collection Account Number (TAN)	Type of Form	Due date for furnishing	Date of furnishing, if furnished	Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported

(c) whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish:

Tax deduction and collection Account Number (TAN)	Amount of interest under section 201(1A)/206C(7) is payable	Amount paid out of column (2) along with date of payment.

35. (a) In the case of a trading concern, give quantitative details of principal items of goods traded :

- (i) Opening Stock;
- (ii) purchases during the previous year;
- (iii) sales during the previous year;
- (iv) closing stock;
- (v) shortage/excess, if any

(b) In the case of a manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products :

A. Raw Materials :

- (i) opening stock;
- (ii) purchases during the previous year;
- (iii) consumption during the previous year;
- (iv) sales during the previous year;
- (v) closing stock;
- (vi) yield of finished products;
- (vii) percentage of yield;
- (viii) shortage/excess, if any.

III.414 Auditing Pronouncements

- B. Finished products/by- products :
- (i) opening stock;
 - (ii) purchases during the previous year;
 - (iii) quantity manufactured during the previous year;
 - (iv) sales during the previous year;
 - (v) closing stock;
 - (vi) shortage/excess, if any.
36. In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form :-
- (a) total amount of distributed profits;
 - (b) amount of reduction as referred to in section 115-O(1A)(i);
 - (c) amount of reduction as referred to in section 115-O(1A)(ii);
 - (d) total tax paid thereon;
 - (e) dates of payment with amounts.
37. Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor.
38. Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.
39. Whether any audit was conducted under section 72A of the Finance Act, 1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.
40. Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:

S. No	Particulars	Previous year	Preceding previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		
4.	Stock-in-trade/turnover		

5.	Material consumed/finished goods produced		
----	---	--	--

(The details required to be furnished for principal items of goods traded or manufactured or services rendered)

41. Please furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 alongwith details of relevant proceedings.

.....

*(Signature and stamp/Seal of the signatory)

Place:_____

Name of the signatory

Date:_____

Full address.....

Notes:

1. *This Form has to be signed by the person competent to sign Form No. 3CA or Form No. 3CB, as the case may be.

APPENDIX XVIII

COMPARATIVE STATEMENT – OLD AND NEW FORM Nos. 3CA/3CB/3CD

Comparative Statement of Old and New Form No. 3CA

Old Form No. 3CA	New Form No. 3CA
FORM NO. 3CA	FORM NO. 3CA
[See rule 6G(1)(a)]	[See rule 6G(1)(a)]
Audit report under section 44AB of the Income - tax Act, 1961, in a case where the accounts of the business or profession of a person have been audited under any other law	Audit report under section 44AB of the Income - tax Act, 1961, in a case where the accounts of the business or profession of a person have been audited under any other law
* I/We report that the statutory audit of [mention name and address of the assessee with permanent account number] was conducted by * me/us/M/s. in pursuance of the provisions of the....Act, and *I/we annex hereto a copy of * my/our/their audit report datedalong with a copy each of –	*I / we report that the statutory audit of M/s..... (Name and address of the assessee with Permanent Account Number) was conducted by *me / us / M/s.....in pursuance of the provisions of the.... Act, and *I/we annex hereto a copy of * my / our / their audit report datedalong with a copy of each of :-
(a) the audited * profit and loss account/income and expenditure account for the year ended on 31st March,....;	(a) the audited *profit and loss account / income and expenditure account for the <i>period beginning fromto ending on</i>

Old Form No. 3CA	New Form No. 3CA
(b) the audited balance sheet as at 31st March,....; and	(b) the audited balance sheet as at,;and
(c) documents declared by the said Act to be part of, or annexed to, the * profit and loss account/income and expenditure account and balance sheet.	(c) documents declared by the said Act to be part of, or annexed to, the * profit and loss account / income and expenditure account and balance sheet.
2. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No. 3CD.	2. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No. 3CD.
3. In * my/our opinion and to the best of * my/our information and according to explanations given to * me/us, the particulars given in the said Form No. 3CD and the Annexure thereto are true and correct.	3. In *my / our opinion and to the best of * my / our information and <i>according to examination of books of account including other relevant documents</i> and explanations given to *me / us, the particulars given in the said Form No.3 CD are true and correct <i>subject to the following observations/qualifications, if any:</i> a. b. c.
** Signed	** (Signature and stamp/Seal of the signatory)
Place.... Name :....	Place.... Name of the Signatory:....
Date.... Address....	Date.... Full Address....
Notes:	Notes:

III.418 Auditing Pronouncements

Old Form No. 3CA	New Form No. 3CA
1. *Delete whichever is not applicable.	1. * Delete whichever is not applicable
2. **This report has to be signed by- (i) a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949); or (ii) any person who, in relation to any State, is, by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), entitled to be appointed to act as an auditor of companies registered in that State; or (iii) any person who is, by virtue of any other law, entitled to audit the accounts of the assessee for the relevant previous year.	2.**This report has to be signed by a person eligible to sign the report as per the provisions of section 44AB of the Income Tax Act, 1961.
3. Where any of the requirements in this Form is answered in the negative or with qualification, give reasons therefor.	3. Where any of the requirements in this Form is answered in the negative or with qualification, give reasons therefor.
4. The person, who signs this audit report, shall indicate reference of his membership number/certificate of practice number/ authority under which he is entitled to sign this report.	4. The person, who signs this audit report, shall indicate reference of his membership number/certificate of practice number/ authority under which he is entitled to sign this report.

Comparative Statement of Old and New Form No. 3CB

Old Form No. 3CB	New Form No. 3CB
FORM NO. 3CB	FORM NO. 3CB
[See rule 6G(1)(b)]	[See rule 6G(1)(b)]
Audit report under section 44AB of the Income - tax Act 1961, in the case of a person referred to in clause (b) of sub - rule (1) of rule 6G	Audit report under section 44AB of the Income - tax Act 1961, in the case of a person referred to in clause (b) of sub - rule (1) of rule 6G
*I / We have examined the Balance Sheet as at 31 st March...., and the *Profit and Loss Account / Income and Expenditure Account for the year ended on that date, attached herewith, of [Mention Name and Address of the Assessee with permanent Account Number]	1. *I / we have examined the balance sheet as on,, and the *profit and loss account / income and expenditure account for the period beginning from to ending on...., attached herewith, of (Name), (Address), (Permanent Account Number).
2. *I / we certify that the balance sheet and the *profit and loss / income and expenditure account are in agreement with the books of account maintained at the head office at and **.... branches.	2. *I / we certify that the balance sheet and the *profit and loss / income and expenditure account are in agreement with the books of account maintained at the head office at and **.... branches.
3.(a) *I / we report the following observations / comments / discrepancies / inconsistencies; if any:	3.(a) *I / we report the following observations / comments / discrepancies / inconsistencies; if any:
(b) Subject to above, -	(b) Subject to above, -

III.420 Auditing Pronouncements

Old Form No. 3CB	New Form No. 3CB
(A) *I / we have obtained all the information and explanations which, to the best of *my / our knowledge and belief, were necessary for the purposes of the audit.	(A) *I / we have obtained all the information and explanations which, to the best of *my / our knowledge and belief, were necessary for the <i>purpose</i> of the audit..
(B) In *my / our opinion, proper books of account have been kept by the head office and branches of the assessee so far as appears from *my / our examination of the books.	(B) In *my / our opinion, proper books of account have been kept by the head office and branches of the assessee so far as appears from *my / our examination of the books.
(C) In *my / our opinion and to the best of *my / our information and according to the explanations given to *me /us, the said accounts, read with notes thereon, if any, give a true and fair view:-	(C) In *my / our opinion and to the best of *my / our information and according to the explanations given to *me /us, the said accounts, read with notes thereon, if any, give a true and fair view:-
(i) in the case of the balance sheet, of the state of the affairs of the assessee as at 31 st March,... ;and (ii) in the case of the *profit and loss account / income and expenditure account of the *profit / loss or *surplus / deficit of the assessee for the year ended on that date.	(i) in the case of the balance sheet, of the state of the affairs of the assessee as at 31 st March,... ;and (ii) in the case of the *profit and loss account / income and expenditure account of the *profit / loss or *surplus / deficit of the assessee for the year ended on that date.
4. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No.3CD.	4. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No.3CD.

Old Form No. 3CB	New Form No. 3CB
5. In *my/our opinion and to the best of *my / our information and according to explanations given to *me / us, the particulars given in the said Form No.3 CD <u>and the Annexures thereto</u> are true and correct.	5. In *my/our opinion and to the best of *my / our information and according to explanations given to *me / us, the particulars given in the said Form No.3 CD are true and correct <i>subject to following observations/qualifications, if any:</i> a. b. c.
*** Signed	*** <i>(Signature and stamp/Seal of the signatory)</i>
Place.... Name :.... Date.... Address....	Place.... Name of the Signatory:.... Date.... Full Address....
Notes:	Notes:
1. *Delete whichever is not applicable.	1. * Delete whichever is not applicable
2. **Mention the total number of branches.	2. **Mention the total number of branches.
3. ***This report has to be signed by- (i) a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949); or (ii) any person who, in relation to any State, is, by virtue of the provisions of sub-section (2) of section 226 of the	3.***This report has to be signed <i>by a person eligible to sign the report as per the provisions of section 44AB of the Income Tax Act, 1961.</i>

III.422 Auditing Pronouncements

Old Form No. 3CB	New Form No. 3CB
Companies Act, 1956 (1 of 1956), entitled to be appointed to act as an auditor of companies registered in that State;	
4. The person, who signs this audit report, shall indicate reference of his membership number / certificate of practice number / authority under which he is entitled to sign this report.	4. The person, who signs this audit report, shall indicate reference of his membership number / certificate of practice number / authority under which he is entitled to sign this report.

Comparative Statement of Old and New Form No. 3CD

Old Form No. 3CD	New From No. 3CD
1. Name of the Assessee	1. Name of the assessee
2. Address	2. Address
3. Permanent Account Number	3. Permanent Account Number (PAN)
	4. <i>Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty, etc. if yes, please furnish the registration number or any other identification number allotted for the same</i>

Old Form No. 3CD	New From No. 3CD
4. Status	5. Status
5. Previous year ended: 31st March _____	6. Previous year <i>from</i> <i>to</i>
6. Assessment year	7. Assessment year
	<i>8. Indicate the relevant clause of section 44AB under which the audit has been conducted</i>
Part – B	Part – B
7. (a) If Firm or Association of Persons, indicate names of Partners/Members and their, Profit Sharing Ratios.	9. (a) If firm or association of persons, indicate names of partners/members and their profit sharing ratios.
(b) If there is any change in the Partners or Members or in their Profit Sharing Ratio since the last date of the preceding year, the particulars of such change.	(b) If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change
8. (a) Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession).	10. (a) Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession)
(b) If there is any change in the nature of business or profession, the particulars of such change.	(b) If there is any change in the nature of business or profession, the particulars of such change.

III.424 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD
9. (a) Whether Books of Account are prescribed under Section 44AA, if yes, list of books so prescribed.	11. (a) Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.
(b) Books of account maintained. (In case Books of Account are maintained in a computer system, mention the books of account generated by such computer system)	(b) <i>List of books of account maintained and the address at which the books of accounts are kept.</i> (In case books of account are maintained in a computer system, mention the books of account generated by such computer system. <i>If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.</i>)
(c) List of books of account examined.	(c) List of books of account <i>and nature of relevant documents</i> examined.
10. Whether the Profit and Loss Account includes any Profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant section (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB or any other relevant section).	12. Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant section (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, <i>Chapter XII-G, First Schedule</i> or any other relevant section.)
11. (a) Method of accounting employed in the previous year.	13. (a) Method of accounting employed in the previous year
(b) Whether there has been any change in the method of accounting employed vis-à-vis the method employed in the immediately preceding previous year.	(b) Whether there <i>had</i> been any change in the method of accounting employed vis-a-vis the method employed in the immediately preceding previous year
(c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the	(c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

Old Form No. 3CD	New From No. 3CD			
Profit or Loss.	<i>Serial number</i>	<i>Particulars</i>	<i>Increase in profit (Rs.)</i>	<i>Decrease in profit (Rs.)</i>
(d) Details of deviation, if any, in the method of accounting employed in the previous year from Accounting Standards prescribed under Section 145 and the effect thereof on the Profit or Loss.	(d) Details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.			
12. (a) Method of Valuation of Closing Stock employed in the previous year.	<i>Serial number</i>	<i>Particulars</i>	<i>Increase in profit (Rs.)</i>	<i>Decrease in profit (Rs.)</i>
(b) Details of deviation, if any, from the method of valuation prescribed under Section 145A, and the effect thereof on the Profit or Loss.	(b) <i>In case of deviation from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish:</i>			
(A) Give the following particulars of the Capital Asset converted into Stock in Trade:— (a)Description of Capital Asset (b)Date of Acquisition (c)Cost of Acquisition (d)Amount at which the Asset is converted into Stock in Trade.	15. Give the following particulars of the capital asset converted into stock-in trade: - (a) Description of capital asset; (b) Date of acquisition; (c) Cost of acquisition; (d) Amount at which the asset is converted into stock-in-trade			
13. Amounts not credited to the Profit and Loss	16. Amounts not credited to the profit and loss account, being, -			

III.426 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD								
Account, being –									
(a) the items falling within the scope of Section 28;	(a) the items falling within the scope of section 28;								
(b) the proforma credits, drawbacks, refund of duty of customs or excise or service tax, or refunds of sales tax or value added tax, where such credits, drawbacks or refunds are admitted as due by the authorities concerned	(b) the pro forma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax where such credits, drawbacks or refunds are admitted as due by the authorities concerned;								
(c) Escalation Claims accepted during the previous year;	(c) escalation claims accepted during the previous year;								
(d) any other item of income;	(d) any other item of income;								
(e) capital receipt, if any.	(e) capital receipt, if any.								
	<p>17. Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, please furnish:</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center;">Serial number</th> <th style="text-align: center;">Particulars</th> <th style="text-align: center;">Increase in profit (Rs.)</th> <th style="text-align: center;">Decrease in profit (Rs.)</th> </tr> </thead> <tbody> <tr> <td style="height: 20px;"></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>	Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)				
Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)						
14. Particulars of depreciation allowable as per the Income–Tax Act, 1961 in respect of each asset or	18. Particulars of depreciation allowable as per the Income Tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following								

Old Form No. 3CD	New From No. 3CD						
block of assets, as the case may be, in the following form :—	form :-						
(a) Description of asset/block of assets.	(a) Description of asset/block of assets.						
(b) Rate of depreciation.	(b) Rate of depreciation.						
(c) Actual Cost or Written Down Value, as the case may be.	(c) Actual cost of written down value, as the case may be.						
(d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of—	(d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –						
(i) Modified Value Added Tax Credit claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March 1994,	i) <i>Central</i> Value Added Tax credits claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,						
(ii) Change in Rate of Exchange of Currency, and	ii) change in rate of exchange of currency, and						
(iii) Subsidy or Grant or Reimbursement, by whatever name called.	iii) subsidy or grant or reimbursement, by whatever name called.						
(e) Depreciation allowable.	(e) Depreciation allowable.						
(f) Written down value at the end of the year.	(f) Written down value at the end of the year						
15. Amounts admissible under Sections-	19. Amounts admissible under sections:						
(a) 33AB	<table border="1"> <thead> <tr> <th>Section</th> <th>Amount debited to</th> <th>Amounts admissible as per the</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> </tr> </tbody> </table>	Section	Amount debited to	Amounts admissible as per the			
Section	Amount debited to	Amounts admissible as per the					

III.428 Auditing Pronouncements

Old Form No. 3CD	New Form No. 3CD		
(b) 33ABA (c) 33AC (wherever applicable) (d) 35 (e) 35ABB (f) 35AC (g) 35CCA (h) 35CCB (i) 35D (j) 35DD (k) 35DDA (l) 35E:- (a) debited to the Profit and Loss Account (showing the amount debited and deduction allowable under each section separately); (b) not debited to the Profit and Loss Account		<i>profit and loss account</i>	<i>provisions of the Income Tax Act, 1961 and also fulfils the conditions, if any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.</i>
	32AC		
	33AB		
	33ABA		
	35(1)(i)		
	35(1)(ii)		
	35(1)(iia)		
	35(1)(iii)		
	35(1)(iv)		
	35(2AA)		
	35(2AB)		
	35ABB		
	35AC		
	35AD		
	35CCA		
35CCB			

Old Form No. 3CD	New Form No. 3CD					
	35CCC					
	35CCD					
	35D					
	35DD					
	35DDA					
	35E					
16. (a) Any sum paid to an Employee as Bonus or Commission for services rendered, where such sum was otherwise payable to him as Profits or Dividend. [Section 36(1)(ii)]	20. (a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)]					
(b) Any sum received from Employees towards Contributions to any Provident Fund or Superannuation Fund or any other fund mentioned in Section 2(24)(x); and due date for payment and the actual date of payment to the concerned authorities under Section 36(1)(va).	(b) <i>Details of contributions</i> received from employees for various funds as referred to in section 36(1)(va):					
	<i>Serial number</i>	<i>Nature of fund</i>	<i>Sum received from employees</i>	<i>Due date for payment</i>	<i>The actual amount paid</i>	<i>The actual date of payment to the concerned authorities</i>
17. Amounts debited to the Profit and Loss Account,	21. (a) <i>Please furnish the details of</i> amounts debited to the profit and loss					

III.430 Auditing Pronouncements

Old Form No. 3CD	New Form No. 3CD			
being :- (a) expenditure of capital nature; (b) expenditure of personal nature; (c) expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party; (d) expenditure incurred at clubs, — (i) as entrance fees and subscriptions; (ii) as cost for club services and facilities used; (e) (i) expenditure by way of penalty or fine for violation of any law for the time being in force; (ii) any other penalty or fine; (iii) expenditure incurred for any purpose which is an offence or which is prohibited by law;	account, being <i>in the nature of capital, personal, advertisement expenditure etc</i>			
	<i>Nature</i>	<i>Serial number</i>	<i>Particulars</i>	<i>Amount in Rs.</i>
	Capital expenditure			
	Personal expenditure			
	Advertisement expenditure in any souvenir, brochure, tract, pamphlet or the like published by a political party			
	Expenditure incurred at clubs being entrance fees and subscriptions			
	Expenditure incurred at			

Old Form No. 3CD	New From No. 3CD			
	clubs being cost for club services and facilities used.			
	Expenditure by way of penalty or fine for violation of any law for the time being force			
	Expenditure by way of any other penalty or fine <i>not covered above</i>			
	Expenditure incurred for any purpose which is an offence or which is prohibited by law			
(f) amounts inadmissible under Section 40(a);	<p>(b) <i>Amounts inadmissible under section 40(a):-</i></p> <p>(i) <i>as payment to non-resident referred to in sub-clause (i)</i></p> <p>(A) <i>Details of payment on which tax is not deducted:</i></p> <p>(I) <i>date of payment</i></p> <p>(II) <i>amount of payment</i></p>			

III.432 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD
	<p>(III) <i>nature of payment</i></p> <p>(IV) <i>name and address of the payee</i></p> <p>(B) <i>Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)</i></p> <p>(I) <i>date of payment</i></p> <p>(II) <i>amount of payment</i></p> <p>(III) <i>nature of payment</i></p> <p>(IV) <i>name and address of the payee</i></p> <p>(V) <i>amount of tax deducted</i></p> <p>(ii) <i>as payment referred to in sub-clause (ia)</i></p> <p>(A) <i>Details of payment on which tax is not deducted:</i></p> <p>(I) <i>date of payment</i></p> <p>(II) <i>amount of payment</i></p> <p>(III) <i>nature of payment</i></p> <p>(IV) <i>name and address of the payee</i></p> <p>(B) <i>Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub- section (1) of section</i></p>

Old Form No. 3CD	New From No. 3CD
	139. (I) <i>date of payment</i> (II) <i>amount of payment</i> (III) <i>nature of payment</i> (IV) <i>name and address of the payer</i> (V) <i>amount of tax deducted</i> (VI) <i>amount out of (V) deposited, if any</i> (iii) <i>under sub-clause (ic) [Wherever applicable]</i> (iv) <i>under sub-clause (iia)</i> (v) <i>under sub-clause (iib)</i> (vi) <i>under sub-clause (iii)</i> (A) <i>date of payment</i> (B) <i>amount of payment</i> (C) <i>name and address of the payee</i> (vii) <i>under sub-clause (iv)</i> (viii) <i>under sub-clause (v)</i>
(g) Interest, Salary, Bonus, Commission or Remuneration inadmissible under Section	(c) Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and

III.434 Auditing Pronouncements

Old Form No. 3CD	New Form No. 3CD																				
<p>40(b)/40(ba) and computation thereof;</p> <p>(h) (A) Whether a Certificate has been obtained from the Assessee regarding payments relating to any expenditure covered under Section 40A(3) that the payments were made by Account Payee Cheques drawn on a Bank or Account Payee Bank Draft, as the case may be, [Yes/No]</p> <p>(B) amount inadmissible under Section 40A(3), read with Rule 6 DD [with break-up of inadmissible amounts];</p>	<p>computation thereof;</p> <p>(d) <i>Disallowance/deemed income under section 40A(3):</i></p> <p>(A) <i>On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:</i></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center;"><i>Serial number</i></th> <th style="text-align: center;"><i>Date of payment</i></th> <th style="text-align: center;"><i>Nature of payment</i></th> <th style="text-align: center;"><i>Amount</i></th> <th style="text-align: center;"><i>Name and Permanent Account Number of the payee, if available</i></th> </tr> </thead> <tbody> <tr> <td style="height: 20px;"> </td> <td> </td> <td> </td> <td> </td> <td> </td> </tr> </tbody> </table> <p>(B) <i>On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);</i></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center;"><i>Serial number</i></th> <th style="text-align: center;"><i>Date of payment</i></th> <th style="text-align: center;"><i>Nature of payment</i></th> <th style="text-align: center;"><i>Amount</i></th> <th style="text-align: center;"><i>Name and Permanent Account Number of the payee, if available</i></th> </tr> </thead> <tbody> <tr> <td style="height: 20px;"> </td> <td> </td> <td> </td> <td> </td> <td> </td> </tr> </tbody> </table>	<i>Serial number</i>	<i>Date of payment</i>	<i>Nature of payment</i>	<i>Amount</i>	<i>Name and Permanent Account Number of the payee, if available</i>						<i>Serial number</i>	<i>Date of payment</i>	<i>Nature of payment</i>	<i>Amount</i>	<i>Name and Permanent Account Number of the payee, if available</i>					
<i>Serial number</i>	<i>Date of payment</i>	<i>Nature of payment</i>	<i>Amount</i>	<i>Name and Permanent Account Number of the payee, if available</i>																	
<i>Serial number</i>	<i>Date of payment</i>	<i>Nature of payment</i>	<i>Amount</i>	<i>Name and Permanent Account Number of the payee, if available</i>																	

Old Form No. 3CD	New From No. 3CD
(i) provision for payment of gratuity not allowable under Section 40A(7); (j) any sum paid by the Assessee as an employer not allowable under section 40A(9); (k) particulars of any liability of a contingent nature. (l) amount of deduction inadmissible in terms of section 14 A in respect of the expenditure incurred in relation to income which does not form part of the total income; (m) amount inadmissible under the proviso to section 36(1)(iii)	(e) provision for payment of gratuity not allowable under section 40A(7); (f) any sum paid by the assessee as an employer not allowable under section 40A(9); (g) particulars of any liability of a contingent nature; (h) amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income; (l) amount inadmissible under the proviso to section 36(1)(iii).
17A. Amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.	22. Amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.
18. Particulars of payments made to persons specified under Section 40A(2)(b).	23. Particulars of payments made to persons specified under section 40A(2)(b).
19. Amounts deemed to be Profits and Gains under Section 33AB or 33ABA or 33AC.	24. Amounts deemed to be profits and gains under section 32AC or 33AB or 33ABA or 33AC.

III.436 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD
20. Any amount of Profit chargeable to tax under Section 41 and computation thereof.	25. Any amount of profit chargeable to tax under section 41 and computation thereof.
21.*(i) In respect of any sum referred to in clauses (a), (b), (c), (d), (e) or (f) of section 43B, the liability for which:-	26. In respect of any sum referred to in clause (a),(b), (c), (d), (e) or (f) of section 43B, the liability for which:-
<p>(A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was –</p> <p>(a) paid during the previous year;</p> <p>(b) not paid during the previous year;</p> <p>(B) was incurred in the previous year and was</p> <p>(a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);</p> <p>(b) not paid on or before the aforesaid date.</p> <p>(ii) [***]</p> <p>* State whether Sales Tax, Customs Duty, Excise Duty or any other Indirect Tax, Cess, Import, etc. is passed through the Profit and Loss Account.</p>	<p>(A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was</p> <p>(a) paid during the previous year;</p> <p>(b) not paid during the previous year;</p> <p>(B) was incurred in the previous year and was</p> <p>(a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);</p> <p>(b) not paid on or before the aforesaid date.</p> <p>(State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost, etc., is passed through the profit and loss account.)</p>

Old Form No. 3CD	New From No. 3CD
<p>22. (a) Amount of Modified Value Added Tax credits availed of or utilised during the previous year and its treatment in the Profit and Loss Account and treatment of outstanding Modified Value Added Tax credits in the accounts.</p> <p>(b) Particulars of income or expenditure of prior period credited or debited to the Profit and Loss Account.</p>	<p>27. (a) Amount of <i>Central</i> Value Added Tax credits availed of or utilised during the previous year and its treatment in the profit and loss account and treatment of outstanding <i>Central</i> Value Added Tax credits in the accounts.</p> <p>(b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account.</p>
	<p>28. <i>Whether during the previous year the assessee has received any property, being share of a company not being a company in which the public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viiia), if yes, please furnish the details of the same.</i></p>
	<p>29. <i>Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same.</i></p>
<p>23. Details of any amount borrowed on Hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an Account Payee Cheque. [Section 69D]</p>	<p>30. Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. [Section 69D]</p>
<p>24. (a)* Particulars of each Loan or Deposit in an amount exceeding the limit specified in Section 269SS</p>	<p>31. * (a) Particulars of each loan or deposit in an amount exceeding the limit</p>

III.438 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD
<p>taken or accepted during the previous year:—</p> <p>(i) Name, Address and Permanent Account Number (if available with the Assessee) of the Lender or Depositor;</p> <p>(ii) Amount of Loan or Deposit taken or accepted;</p> <p>(iii) Whether the Loan or Deposit was squared up during the previous year;</p> <p>(iv) Maximum Amount outstanding in the account at any time during the previous year;</p> <p>(v) Whether the Loan or Deposit was taken or accepted otherwise than by an Account Payee Cheque or an Account Payee Bank Draft.</p> <p>*(These particulars need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)</p> <p>(b) Particulars of each repayment of Loan or Deposit in an amount exceeding the limit specified in Section 269T made during the previous year:—</p> <p>(i) Name, Address and Permanent Account Number (if available with the Assessee) of the payee;</p> <p>(ii) Amount of the repayment;</p>	<p>specified in section 269SS taken or accepted during the previous year :-</p> <p>(i) name, address and permanent account number (if available with the assessee) of the lender or depositor;</p> <p>(ii) amount of loan or deposit taken or accepted;</p> <p>(iii) whether the loan or deposit was squared up during the previous year;</p> <p>(iv) maximum amount outstanding in the account at any time during the previous year;</p> <p>(v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.</p> <p>* (These particulars needs not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)</p> <p>(b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year :-</p> <p>(i) name, address and Permanent Account Number (if available with the assessee) of the payee;</p> <p>(ii) amount of the repayment;</p> <p>(iii) maximum amount outstanding in the account at any time during the previous year;</p> <p>(iv) whether the repayment was made otherwise than by account payee</p>

Old Form No. 3CD						New Form No. 3CD																													
<p>(iii) Maximum Amount outstanding in the account at any time during the previous year;</p> <p>(iv) Whether the repayment was made otherwise than by Account Payee Cheque or Account Payee Bank Draft.</p> <p>(c) Whether a Certificate has been obtained from the assessee regarding taking or accepting Loan or Deposit, or repayment of the same through an Account Payee Cheque or an Account Payee Bank Draft. [Yes/No]</p> <p>The particulars (i) to (iv) at (b) and the Certificate at (c) above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government Company, Banking Company or a Corporation established by a Central, State or Provincial Act.</p>						<p>cheque or account payee bank draft.</p> <p>(c) Whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque <i>drawn on a bank</i> or account payee bank draft <i>based on the examination of books of account and other relevant documents</i></p> <p>(The particulars (i) to (iv) at (b) and <i>comment at (c)</i> above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act)</p>																													
<p>25. (a) Details of Brought Forward Loss or Depreciation Allowance, in the following manner, to the extent available:</p> <table border="1"> <thead> <tr> <th>S. No</th> <th>Assessment</th> <th>Nature of loss/</th> <th>Amount as</th> <th>Amount as</th> <th>Remarks</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>						S. No	Assessment	Nature of loss/	Amount as	Amount as	Remarks							<p>32.(a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available :</p> <table border="1"> <thead> <tr> <th>Serial Number</th> <th>Assessment Year</th> <th>Nature of loss / allowanc</th> <th>Amount as returned</th> <th>Amounts as assessed</th> <th>Remarks</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>						Serial Number	Assessment Year	Nature of loss / allowanc	Amount as returned	Amounts as assessed	Remarks						
S. No	Assessment	Nature of loss/	Amount as	Amount as	Remarks																														
Serial Number	Assessment Year	Nature of loss / allowanc	Amount as returned	Amounts as assessed	Remarks																														

III.440 Auditing Pronouncements

Old Form No. 3CD						New From No. 3CD					
year	allowance (in rupees)	returned (in rupees)	assessed (give reference to relevant order)				e (in rupees)	(in rupees)	(give reference to relevant order)		
<p>(b) Whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the Previous Year cannot be allowed to be carried forward in terms of Section 79.</p>						<p>(b) Whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.</p>					
						<p>(c) <i>Whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, If yes, please furnish the details of the same.</i></p> <p>(d) <i>whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same.</i></p> <p>(e) <i>In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year.</i></p>					
26. Section-wise details of deductions, if any,						33. Section-wise details of deductions, if any, admissible under Chapter VIA					

Old Form No. 3CD	New From No. 3CD																													
admissible under Chapter VIA.	<p>or Chapter III (Section 10A, Section 10AA).</p> <table border="1" data-bbox="947 464 1743 716"> <tr> <td data-bbox="947 464 1278 716">Section under which deduction is claimed</td> <td data-bbox="1278 464 1743 716">Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules, 1962 or any other guidelines, circular, etc, issued in this behalf.</td> </tr> <tr> <td> </td> <td> </td> </tr> </table>										Section under which deduction is claimed	Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules, 1962 or any other guidelines, circular, etc, issued in this behalf.																		
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<p>27. (a) Whether the Assessee has complied with the provisions of Chapter XVII-B regarding deduction of tax at source and regarding the payment thereof to the credit of the Central Government.[Yes/No]</p> <p>(b) If the provisions of Chapter XVII-B have not been complied with, please give the following details * , namely:-</p> <p>(i) Tax Deductible and not deducted at all</p> <p>(ii) Shortfall on account of lesser deduction than required to be deducted.</p> <p>(iii) Tax Deducted late</p> <p>(iv) Tax Deducted but not paid to the credit of the Central Government</p>	<p>34. (a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:</p> <table border="1" data-bbox="947 846 1743 1227"> <thead> <tr> <th data-bbox="947 846 1024 1227">Tax deduction and collection Account Number (TAN)</th> <th data-bbox="1024 846 1102 1227">Section</th> <th data-bbox="1102 846 1180 1227">Nature of payment</th> <th data-bbox="1180 846 1260 1227">Total amount of payment or receipt of the nature specified</th> <th data-bbox="1260 846 1337 1227">Total amount on which tax was required to be deducted or</th> <th data-bbox="1337 846 1415 1227">Total amount on which tax was deducted or collected at speci</th> <th data-bbox="1415 846 1493 1227">Amount of tax deducted or collected out of (6)</th> <th data-bbox="1493 846 1570 1227">Total amount on which tax was deducted or collected at less</th> <th data-bbox="1570 846 1648 1227">Amount of tax deducted or collected on (8)</th> <th data-bbox="1648 846 1743 1227">Amount of tax deducted or collected not deposited to the</th> </tr> </thead> <tbody> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> </tr> </tbody> </table>										Tax deduction and collection Account Number (TAN)	Section	Nature of payment	Total amount of payment or receipt of the nature specified	Total amount on which tax was required to be deducted or	Total amount on which tax was deducted or collected at speci	Amount of tax deducted or collected out of (6)	Total amount on which tax was deducted or collected at less	Amount of tax deducted or collected on (8)	Amount of tax deducted or collected not deposited to the										
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III.442 Auditing Pronouncements

Old Form No. 3CD	New Form No. 3CD																			
*Please give the details of cases covered in (i) to (iv) above.				<i>in colu mn (3)</i>	<i>collec ted out of (4)</i>	<i>fied rate out of (5)</i>		<i>than speci fied rate out of (7)</i>		<i>credit of the Centr al Gove rnme nt out of (6) and (8)</i>										
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)										
	<p>(b) <i>whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details:</i></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center;"><i>Tax deduction and collection Account Number (TAN)</i></th> <th style="text-align: center;"><i>Type of Form</i></th> <th style="text-align: center;"><i>Due date for furnishing</i></th> <th style="text-align: center;"><i>Date of furnishing, if furnished</i></th> <th style="text-align: center;"><i>Whether the statement of tax deducted or collected contains information about all transactions which are</i></th> </tr> </thead> <tbody> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td> </td> </tr> </tbody> </table>										<i>Tax deduction and collection Account Number (TAN)</i>	<i>Type of Form</i>	<i>Due date for furnishing</i>	<i>Date of furnishing, if furnished</i>	<i>Whether the statement of tax deducted or collected contains information about all transactions which are</i>					
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Old Form No. 3CD	New From No. 3CD			
				<i>required to be reported</i>
	<i>(c) whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish:</i>			
	<i>Tax deduction and collection Account Number (TAN)</i>	<i>Amount of interest under section 201(1A)/206C(7) is payable</i>	<i>Amount paid out of column (2) along with date of payment.</i>	
<p>28. (a) In the case of a Trading Concern, give quantitative details of principal items of goods traded:</p> <p>(i) Opening Stock;</p> <p>(ii) Purchases during the previous year;</p> <p>(iii) Sales during the previous year</p> <p>(iv) Closing Stock;</p> <p>(v) Shortage/excess, if any</p> <p>(b) In the case of a Manufacturing Concern, give quantitative details of the principal items of Raw Materials, Finished Products and By-Products :</p> <p>A. Raw Materials:</p>	<p>35. (a) In the case of a trading concern, give quantitative details of principal items of goods traded :</p> <p>(i) Opening Stock;</p> <p>(ii) Purchases during the previous year;</p> <p>(iii) Sales during the previous year</p> <p>(iv) Closing Stock;</p> <p>(v) Shortage/excess, if any</p> <p>(b) In the case of a Manufacturing Concern, give quantitative details of the principal items of Raw Materials, Finished Products and By-Products :</p> <p>A. Raw Materials:</p>			

III.444 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD
(i) Opening Stock; (ii) Purchases during the previous year; (iii) Consumption during the previous year; (iv) Sales during the previous year; (v) Closing stock; (vi) *Yield of Finished Products; (vii) *Percentage of yield; (viii) *Shortage/excess, if any. B. Finished products/by-products: (i) Opening Stock; (ii) Purchases during the previous year; (iii) Quantity manufactured during the previous year; (iv) Sales during the previous year; (v) Closing stock; (vi) Shortage/excess, if any. *Information may be given to the extent available.	(i) Opening Stock; (ii) Purchases during the previous year; (iii) Consumption during the previous year; (iv) Sales during the previous year; (v) Closing stock; (vi) Yield of Finished Products; (vii) Percentage of yield; (viii) Shortage/excess, if any. B. Finished products/by-products: (i) Opening Stock; (ii) Purchases during the previous year; (iii) Quantity manufactured during the previous year; (iv) Sales during the previous year; (v) Closing stock; (vi) Shortage/excess, if any.
29. In the case of a Domestic Company, details of Tax on Distributed Profits under Section 115O in the following form – (a) Total Amount of distributed profits;	36. In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form:- (a) total amount of distributed profits; (b) amount of reduction as referred to in section 115-O(1A)(i);

Old Form No. 3CD	New From No. 3CD			
(b) Total Tax paid thereon; (c) Dates of Payment with amounts.	(c) amount of reduction as referred to in section 115-O(1A)(ii); (d) total tax paid thereon; (e) dates of payment with amounts.			
30. Whether any Cost Audit was carried out, if yes, enclose a copy of the report of such audit [See section 139(9)].	37. Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor.			
31. Whether any audit was conducted under the Central Excise Act, 1944, if yes, enclose a copy of the report of such audit.	38. Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported /identified by the auditor.			
	39. Whether any audit was conducted under section 72A of the Finance Act, 1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.			
32. Accounting ratios with calculations as follows: – (a) Gross Profit/Turnover; (b) Net Profit/Turnover; (c) Stock-in-Trade/Turnover; (d) Material Consumed / Finished Goods produced.	40. Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:			
	Serial number	Particulars	Previous year	Preceding previous year
	1.	Total turnover of the assessee		
	2.	Gross profit/turnover		

III.446 Auditing Pronouncements

Old Form No. 3CD	New From No. 3CD			
	3.	Net profit/turnover		
	4.	Stock-in-trade/turnover		
	5.	Material consumed/finished goods produced		
	<i>(The details required to be furnished for principal items of goods traded or manufactured or services rendered)</i>			
	41. Please furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 along with details of relevant proceedings.			
*Signed *(Signature and stamp/Seal of the signatory)			
Place :..... Name:..	Place: _____		Name of the signatory.....	
Date:..... Address:.....	Date: _____		Full address	
Notes: 1. The Annexure to this Form must be filled up failing	Notes: 1. *This Form has to be signed by the person competent to sign Form			

Old Form No. 3CD	New From No. 3CD
which the Form will be considered as incomplete. 2. This Form and the Annexure have to be signed by the person competent to sign Form No.3CA or Form No.3CB, as the case may be.	No. 3CA or Form No. 3CB, as the case may be.

GUIDANCE NOTE ON REPORTS OR CERTIFICATES FOR SPECIAL PURPOSES (REVISED 2016)

Introduction

1. The purpose of this Guidance Note is to provide guidance on engagements which require a 'professional accountant in public practice' (hitherto known as "practitioner")¹ to issue reports other than those which are issued in audits or reviews of historical financial information². The reports which are issued pursuant to audits or reviews of historical financial information are dealt with in Standards on Auditing (SAs) and Standards on Review Engagements (SREs), respectively, issued by the Institute of Chartered Accountants of India (ICAI).

2. In some cases, Government and other authorities under various statutes or notifications require reports or certificates from practitioners in support of statements or other information provided by an entity. Such reports or certificates can also be required to be issued to fulfill a contractual reporting obligation or may be required by the management or those charged with governance of an entity for its own special purposes.

3. Sometimes, the applicable law and regulation or a contractual arrangement that an entity might have entered into, prescribe the wording of report or certificates. The wording often requires the use of word or phrase like "certify" or "true and correct" to indicate absolute level of assurance expected to be provided by the practitioner on the subject matter. Absolute assurance indicates that a practitioner has performed procedures as considered appropriate to reduce the engagement risk³ to zero.

4. A practitioner is expected to provide either a reasonable assurance (about whether the subject matter of examination is materially misstated) or a limited assurance (stating that nothing has come to the practitioner's attention that causes the practitioner to believe that the subject matter is materially misstated). A practitioner is not expected to reduce the engagement risk to zero. This is because there are inherent limitations attached to the procedures which a practitioner may perform in relation to issuance of a report or certificate, as the case may be. The inherent limitations arise from:

- (a) the nature of financial reporting;

¹ The term "Professional accountant in public practice" has the same meaning as given in the Framework for Assurance Engagements, issued by the Institute of Chartered Accountants of India in 2007.

² For meaning of the term "Historical Financial Information", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

³ For meaning of the term "Engagement Risk", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

- (b) the use of selective testing;
- (c) the inherent limitations of internal controls;
- (d) the fact that much of the evidence⁴ available to the practitioner is persuasive rather than conclusive;
- (e) the nature of procedures to be performed in a specific situation;
- (f) the use of professional judgment⁵ in gathering and evaluating evidence and forming conclusions based on that evidence;
- (g) in some cases, the characteristics of the underlying subject matter⁶ when evaluated or measured against the criteria⁷; and
- (h) the need for the engagement to be conducted within a reasonable period of time and at a reasonable cost.

5. In view of the above, depending upon the nature, timing and extent of procedures that can be performed based upon the facts and circumstances of the case, a report or certificate issued by a practitioner can provide either reasonable or limited level of assurance. Therefore, whenever a practitioner is required to give a “certificate” or a “report” for special purpose, the practitioner needs to undertake a careful evaluation of the scope of the engagement, i.e., whether the practitioner would be able to provide reasonable assurance or limited assurance on the subject matter.

6. The word ‘certificate’ as described in the laws and regulations or even in the contracts that an entity might have entered into can normally be associated with reasonable assurance. However, depending upon the circumstances and based upon the nature, timing and extent of the procedures which a practitioner can perform, the practitioner can conclude that a reasonable assurance cannot be expressed on the subject matter of the “certificate” and only limited assurance conclusion can be given. The practitioner’s procedures in case where reasonable assurance is to be expressed would be substantially different (and more extensive) from circumstances where limited assurance is to be expressed. The Guidance Note, at relevant places, lists the different procedures to be performed in a reasonable assurance engagement *vis a vis* limited assurance engagement. Accordingly, for the purpose of this Guidance Note, the terms, “report” / “certificate” indicates an “assurance report” issued in compliance with this Guidance Note.

7. Assurance engagements include both assertion based engagements⁸, in which a party

⁴ For meaning of the term “Evidence”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

⁵ For meaning of the term “Professional Judgment”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

⁶ For meaning of the term “Underlying Subject Matter”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

⁷ For meaning of the term “Criteria”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

⁸ For meaning of the term “Assertion based Engagements”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

III.450 Auditing Pronouncements

other than the practitioner measures or evaluates the underlying subject matter against the criteria, and direct reporting engagements⁹, in which the practitioner measures or evaluates the underlying subject matter against the criteria. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users'¹⁰ confidence about the subject matter information¹¹ to a degree that is clearly more than inconsequential.

8. The Guidance Note should be read in the context of the Framework for Assurance Engagements, issued by the Institute of Chartered Accountants of India (ICAI). **Appendix 1** to the Guidance Note contains a glossary of certain important terms used in the Guidance Note and is an integral part of the Guidance Note. Further, for the purposes of this Guidance Note, reference to “appropriate party(ies)” should be read hereafter as “the responsible party¹², the measurer¹³ or the evaluator¹⁴, or the engaging party¹⁵, as appropriate.”

Scope

9. This Guidance Note covers assurance engagements¹⁶ other than audits or reviews of historical financial information, as described in the *Framework for Assurance Engagements* (Assurance Framework) issued by the ICAI. This Guidance Note does not apply to assurance engagements for which subject specific Standards on Assurance Engagements have been issued by the ICAI.

10. Not all engagements performed by the practitioners are assurance engagements. Some frequently performed engagements that are not assurance engagements, and therefore not covered by the Guidance Note, include:

- (a) Engagements covered by Standards on Related Services (SRS), such as agreed-upon procedures and compilation engagements;
- (b) The preparation of tax returns where no assurance opinion/conclusion is expressed; and

⁹ For meaning of the term “Direct Reporting Engagements”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹⁰ For meaning of the term “Intended Users”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹¹ For meaning of the term “Subject Matter Information”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹² For meaning of the term “Responsible Party”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹³ For meaning of the term “Measure”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹⁴ For meaning of the term “Evaluator”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹⁵ For meaning of the term “Engaging Party”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹⁶ For meaning of the term “Assurance Engagements”, refer the Glossary of Terms given in the Appendix 1 to this Guidance Note.

(c) Consulting (or advisory) engagements, such as management and tax consulting.

11. This Guidance Note can also be applied on the reports or certificates related to historical non-financial information that a practitioner may be called upon to issue from time to time. ICAI, from time to time, issues specific Guidance Notes to provide guidance on certain assurance engagements. While complying with the requirements of those specific Guidance Notes, a practitioner may also draw guidance from the principles enunciated in this Guidance Note.

Objectives

12. In conducting an assurance engagement, the objectives of the practitioner are:

(a) To obtain either reasonable assurance¹⁷ or limited assurance¹⁸, as appropriate, about whether the subject matter information is free from material misstatement¹⁹;

(b) To express an opinion (in a reasonable assurance engagement)/a conclusion (in a limited assurance engagement) regarding the outcome of the measurement or evaluation of the underlying subject matter through a written report. The report also describes the basis for the conclusion;

(c) Where the subject matter information is made up of a number of aspects, separate opinion/conclusion may be provided on each aspect. All such separate opinions/conclusions do not need to relate to the same level of assurance. Rather, each opinion/conclusion is expressed in the form that is appropriate to either a reasonable assurance engagement or a limited assurance engagement. References in this Guidance Note to the opinion/conclusion in the assurance report include each opinion/conclusion when separate opinions/conclusions are provided;

(d) To communicate further as required by this Guidance Note.

13. In all cases when reasonable assurance or limited assurance, as appropriate, cannot be obtained and a qualified opinion/conclusion in the practitioner's assurance report is insufficient in the circumstances for the purposes of reporting to the intended users, this Guidance Note requires that the practitioner disclaim an opinion / a conclusion or withdraw (or resign) from the engagement, where withdrawal is possible under applicable law or regulation.

14. The roles played by the responsible party, the measurer or evaluator, and the engaging party can vary. The management and governance structures vary by jurisdiction and by entity,

¹⁷ For meaning of the term "Reasonable Assurance Engagement", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹⁸ For meaning of the term "Limited Assurance Engagement", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

¹⁹ For meaning of the term "Misstatement", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

III.452 Auditing Pronouncements

reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. Such diversity means that it is not possible for the Guidance Note to specify for all engagements, the person(s) with whom the practitioner is to inquire of, request representations from, or otherwise communicate with in all circumstances. In some cases, for example, when the appropriate party(ies) is(are) only part of a complete legal entity, identifying the appropriate management personnel or those charged with governance with whom to communicate, will require the exercise of professional judgment to determine which person(s) have the appropriate responsibilities for, and knowledge of, the matters concerned.

Conduct of an Assurance Engagement in Accordance with Guidance Note

15. The Guidance Note aims to bring out the procedural differences between a limited assurance engagement *vis a vis* a reasonable assurance engagement. In this Guidance Note, guidance that applies to only limited assurance or reasonable assurance engagements have been presented in a columnar format with the letter “L” (limited assurance) or “R” (reasonable assurance) after the paragraph number. Although some procedures are required only for reasonable assurance engagements, these may nonetheless be appropriate in some limited assurance engagements.

Inability to Achieve an Objective

16. If any of the objectives enumerated in this Guidance Note (refer paragraphs 12 to 14) cannot be achieved, the practitioner should evaluate whether this requires the practitioner to modify the practitioner’s opinion/conclusion or withdraw from the engagement (where withdrawal is possible under applicable law or regulation). In case the practitioner is unable to achieve an objective, it represents a significant matter requiring documentation in accordance with paragraph 92 of this Guidance Note.

Ethical and Quality Control Requirements

17. A practitioner who performs assurance engagements covered under this Guidance Note is governed by the same ethical and quality control requirements as are described in paragraphs 4 and 5 of the Framework for Assurance Engagements.

Engagement Acceptance and Continuance

18. The practitioner needs to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and assurance engagements have been followed, and should determine that conclusions reached in this regard are appropriate.

19. The practitioner should accept or continue an assurance engagement only when:

(a) The practitioner has no reason to believe that relevant ethical requirements, including

independence, will not be satisfied;

- (b) The practitioner is satisfied that those persons who are to perform the engagement collectively (the engagement team)²⁰ have the appropriate competence and capabilities; and
- (c) The basis upon which the engagement is to be performed has been agreed, through:
 - i. Establishing that the preconditions for an assurance engagement are present (see also paragraphs 21-22); and
 - ii. Confirming that there is a common understanding between the practitioner and the engaging party of the terms of the engagement, including the practitioner's reporting responsibilities.

20. If the practitioner obtains information that would have caused the practitioner to decline the engagement had that information been available earlier, the practitioner should take necessary action promptly. In case of a firm²¹, the practitioner (i.e., the engagement partner²²)²³ should communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

Preconditions for the Assurance Engagement

21. In order to establish whether the preconditions for an assurance engagement are present, the practitioner should, on the basis of a preliminary knowledge of the engagement circumstances²⁴ and discussion with the appropriate party(ies), determine whether:

- (a) The roles and responsibilities of the appropriate parties are suitable in the circumstances; and
- (b) The engagement exhibits all of the following characteristics:
 - (i) The underlying subject matter is appropriate;
 - (ii) The criteria that the practitioner expects to be applied in the preparation of the subject matter information are suitable for the engagement circumstances, including that these exhibit the following characteristics as described in paragraph 35 of the Framework for Assurance Engagements:

²⁰ For meaning of the term "Engagement Team", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

²¹ For meaning of the term "Firm", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

²² For meaning of the term "Engagement Partner", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

²³ In the context of a firm, the term practitioner would imply reference to the engagement partner.

²⁴ For meaning of the term "Engagement Circumstances", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

III.454 Auditing Pronouncements

- a. Relevance.
 - b. Completeness.
 - c. Reliability.
 - d. Neutrality.
 - e. Understandability.
- (iii) The criteria that the practitioner expects to be applied in the preparation of the subject matter information will be available to the intended users²⁵.
- (iv) The practitioner expects to be able to obtain the evidence needed to support the member's conclusion;
- (v) The practitioner's opinion/conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
- (vi) A rational purpose including, in the case of a limited assurance engagement, that the practitioner expects to be able to obtain a meaningful level of assurance.

22. If the preconditions for an assurance engagement are not present, the practitioner should discuss the matter with the engaging party. If changes cannot be made to meet the preconditions, the practitioner would be well advised not to accept the engagement as an assurance engagement, unless required by law or regulation to do so.

Limitation on Scope Prior to Acceptance of the Engagement

23. If the engaging party imposes a limitation on the scope of the practitioner's work in the terms of a proposed assurance engagement, such that the practitioner believes the limitation will result in the practitioner disclaiming an opinion / a conclusion on the subject matter information, the practitioner should not accept such an engagement as an assurance engagement, unless required by law or regulation to do so.

Agreeing on the Terms of the Engagement

24. The practitioner should agree the terms of the engagement with the engaging party. The agreed terms of the engagement should be specified in sufficient detail in an engagement letter or other suitable form of written agreement, written confirmation, or in law or regulation. It is in the interests of both, the engaging party and the practitioner, that the practitioner communicates in writing the agreed terms of the engagement before the commencement of the engagement to help avoid misunderstandings. The terms of engagement, at a minimum, should include the following:

- (a) the objective and scope of engagement;

²⁵ Refer Para 37 of the Framework for Assurance Engagements.

- (b) the responsibilities of the practitioner;
- (c) the responsibilities of engaging party;
- (d) the responsibilities of the responsible party (if different from the engaging party);
- (e) identification of the suitable criteria to be used;
- (f) identification of the subject matter including reference to the law or regulation or the contracts;
- (g) Unrestricted access to whatever records, documentation and other information requested in connection with the engagement;
- (h) The fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist;
- (i) reference to the expected form and content of report to be issued by the practitioner; and
- (j) a statement that there may be circumstances in which a report may differ from its expected form and content.

25. The agreed terms of engagement can also include other general terms of engagement so long as those terms are not inconsistent with the applicable laws and regulations.

26. The form and content of the written agreement or contract will vary with the engagement circumstances. For example, if law or regulation prescribes in sufficient detail the terms of the engagement, the practitioner need not record them in a written agreement, except for the fact that such law or regulation applies and that the appropriate party acknowledges and understands its responsibilities under such law or regulation. Law or regulation, particularly in the public sector, may mandate the appointment of a practitioner and set out specific powers, such as the power to access appropriate party(ies)'s records and other information, and responsibilities, such as requiring the practitioner to report directly to an authority, the legislature or the public, in case appropriate party(ies) attempt to limit the scope of the engagement.

27. On recurring engagements, the practitioner should assess whether the circumstances require the terms of the engagement to be revised and whether there is a need to remind the engaging party of the existing terms of the engagement.

Acceptance of a Change in the Terms of the Engagement

28. The practitioner should not agree to a change in the terms of the engagement where there is no reasonable justification for doing so. If such a change is made, the practitioner should not disregard evidence that was obtained prior to the change. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, may justify a request for a change in the engagement, for example, from an assurance engagement to a non-assurance engagement, or from a reasonable assurance engagement to a limited assurance engagement. An inability to obtain sufficient appropriate evidence to form a

reasonable assurance opinion/conclusion is not an acceptable reason to change from a reasonable assurance engagement to a limited assurance engagement.

Assurance Report Prescribed by Law or Regulation

29. In some cases, law or regulation prescribes the layout or wording of the assurance report. In these circumstances, the practitioner would need to evaluate:

- (a) Whether intended users might misunderstand the assurance conclusion; and
- (b) If so, whether additional explanation in the assurance report can mitigate possible misunderstanding.

30. If the practitioner concludes that additional explanation in the assurance report cannot mitigate possible misunderstanding, as the law or regulation does not allow the practitioner to provide such additional explanation in the assurance report to mitigate the risk of users misunderstanding of the assurance conclusion, the practitioner should not accept the engagement, unless required by law or regulation to do so.

31. In case the practitioner is required to issue an assurance report under the applicable laws or regulations, the practitioner should discuss the matter with the engaging party. The practitioner should provide a draft of the assurance report to be issued that duly incorporates the essential elements thereof as prescribed in paragraph 80 of the Guidance Note to the layout or the wordings so prescribed. Both, the practitioner and the engaging party, should agree on the resulting modifications to the layout or wording prescribed under the laws or regulations. The agreement on layout or wording of the assurance report should be duly documented in the engagement letter. The practitioner should then accept and perform the engagement and issue the final assurance report duly incorporating therein the essential elements prescribed in the Guidance Note. If the engaging party does not agree to this approach, the practitioner should consider whether it would be appropriate to accept the engagement.

32. It may also happen that the concerned authorities reject the aforesaid assurance report issued by the practitioner on account of the modifications made to the prescribed layout or wording. In such circumstances, the practitioner should obtain the evidence of rejection of the assurance report by the concerned authorities and make it a part of the engagement documentation. The practitioner, in such a case, may issue the assurance report in the format prescribed under the law or regulation since the practitioner would have complied with the requirements of this Guidance Note while issuing the certificate in the first instance. The practitioner can also consider enclosing a statement containing essential elements of an assurance report as prescribed in paragraph 80 of this Guidance Note to the format prescribed under the law or regulation. The enclosure should also state the fact that a report issued earlier in accordance with this Guidance Note had been rejected by the concerned authorities.

32A. It is recognised that rejections of assurance reports or certificates issued might have also occurred in the past or there could be a situation where the concerned regulator has expressly indicated that any modification to the layout or the wording of the format is not acceptable and if time period available to follow the process in paragraphs 31 and 32 is not sufficient, the practitioner may issue the assurance report in the format prescribed under the law or regulation. If the practitioner has complied with all the requirements of this Guidance Note, the practitioner should also enclose a statement containing essential elements of an assurance report as prescribed in paragraph 80 of this Guidance Note, to the format prescribed under the law or regulation by giving suitable reference of the statement in the format. (e.g. “in terms of our statement of even date” or “to be read with the enclosed statement of even date” etc.)

33. Similarly, the practitioner may conclude, that even where permitted by the law/regulation or it is otherwise accepted by the concerned regulatory bodies to provide additional information/explanation in the assurance report, doing the same will not mitigate the risk of users’ misunderstanding of the assurance conclusion expressed. In such circumstance, the practitioner should mention the circumstances not allowing the practitioner to bring down the risk of users’ misunderstanding in the report being issued by the practitioner. The practitioner should also include such matters in the scope of work documented in the engagement letter.

Professional Skepticism²⁶, Professional Judgment, and Assurance Skills and Techniques

34. The practitioner would need to plan and perform an engagement with professional skepticism, recognizing that circumstances may exist that may cause the subject matter information to be materiality misstated.

35. The practitioner needs to exercise professional judgment in planning and performing an assurance engagement, including determining the nature, timing and extent of procedures.

36. The practitioner should also apply assurance skills and techniques²⁷ as part of an iterative, systematic engagement process.

Planning

37. The practitioner should plan the engagement so that it will be performed in an effective manner, including setting the scope, timing and direction of the engagement, and determining the nature, timing and extent of planned procedures that are required to be carried out in order to achieve the objective of the engagement.

38. The practitioner should determine whether the criteria are suitable for the engagement circumstances, including that they exhibit the characteristics identified in paragraph 21(b)(ii).

²⁶ For meaning of the term “Professional Skepticism”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

²⁷ For meaning of the term “Assurance Skills and Techniques”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

III.458 Auditing Pronouncements

39. If it is discovered after the engagement has been accepted that one or more preconditions for an assurance engagement is not present, the practitioner should discuss the matter with the appropriate party(ies), and determine:

- (a) Whether the matter can be resolved to the practitioner's satisfaction;
- (b) Whether it is appropriate to continue with the engagement; and
- (c) Whether and, if so, how to communicate the matter in the assurance report.

40. If it is discovered after the engagement has been accepted that some or all of the applicable criteria are unsuitable or some or all of the underlying subject matter is not appropriate for an assurance engagement, the practitioner would need to consider withdrawing from the engagement, if withdrawal is possible under applicable law or regulation. If the practitioner continues with the engagement, the practitioner should express a qualified or adverse opinion/conclusion, or disclaimer of opinion/conclusion, as appropriate in the circumstances.

Materiality

41. The practitioner would consider materiality when:

- (a) Planning and performing the assurance engagement, including when determining the nature, timing and extent of procedures; and
- (b) Evaluating whether the subject matter information is free from material misstatement.

42. Professional judgments about materiality are made in light of surrounding circumstances, but are not affected by the level of assurance, that is, for the same intended users and purpose, materiality for a reasonable assurance engagement is the same as for a limited assurance engagement because materiality is based on the information needs of intended users.

43. The applicable criteria may discuss the concept of materiality in the context of the preparation and presentation of the subject matter information and thereby provide a frame of reference for the practitioner in considering materiality for the engagement. Although applicable criteria may discuss materiality in different terms, the concept of materiality generally includes the matters discussed in paragraphs 42-50. If the applicable criteria do not include a discussion of the concept of materiality, these paragraphs provide the practitioner with a frame of reference.

44. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence relevant decisions of intended users taken on the basis of the subject matter information. The practitioner's consideration of materiality is a matter of professional judgment, and is affected by the practitioner's perception of the common information needs of intended users as a group. In this context, it is reasonable for the practitioner to assume that intended users:

- (a) Have a reasonable knowledge of the underlying subject matter, and a willingness to study

the subject matter information with reasonable diligence;

- (b) Understand that the subject matter information is prepared and assured to appropriate levels of materiality, and have an understanding of any materiality concepts included in the applicable criteria;
- (c) Understand any inherent uncertainties involved in the measuring or evaluating the underlying subject matter; and
- (d) Make reasonable decisions on the basis of the subject matter information taken as a whole.

Unless the engagement has been designed to meet the particular information needs of specific users, the possible effect of misstatements on specific users, whose information needs may vary widely, is not ordinarily considered.

45. Materiality is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative factors and quantitative factors when considering materiality in a particular engagement is a matter for the practitioner's professional judgment.

46. Qualitative factors may include such things as:

- (a) The number of persons or entities affected by the subject matter.
- (b) The interaction between, and relative importance of, various components of the subject matter information when it is made up of multiple components, such as a report that includes numerous performance indicators.
- (c) The wording chosen with respect to subject matter information that is expressed in narrative form.
- (d) The characteristics of the presentation adopted for the subject matter information when the applicable criteria allow for variations in that presentation.
- (e) The nature of a misstatement, for example, the nature of observed deviations from a control when the subject matter information is a statement that the control is effective.
- (f) Whether a misstatement affects compliance with law or regulation.
- (g) In the case of periodic reporting on an underlying subject matter, the effect of an adjustment that affects past or current subject matter information or is likely to affect future subject matter information.
- (h) Whether a misstatement is the result of an intentional act or is unintentional.
- (i) Whether a misstatement is significant having regard to the practitioner's understanding of known previous communications to users, for example, in relation to the expected outcome of the measurement or evaluation of the underlying subject matter.
- (j) Whether a misstatement relates to the relationship between the responsible party, the

III.460 Auditing Pronouncements

measurer or evaluator, or the engaging party or their relationship with other parties.

- (k) When a threshold or benchmark value has been identified, whether the result of the procedure deviates from that value.
- (l) When the underlying subject matter is a governmental program or public sector entity, whether a particular aspect of the program or entity is significant with regard to the nature, visibility and sensitivity of the program or entity.
- (m) When the subject matter information relates to a conclusion on compliance with law or regulation, the seriousness of the consequences of non-compliance.

47. Quantitative factors relate to the magnitude of misstatements relative to reported amounts for those aspects of the subject matter information, if any, that are:

- (a) Expressed numerically; or
- (b) Otherwise related to numerical values (for example, the number of observed deviations from a control may be a relevant quantitative factor when the subject matter information is a statement that the control is effective).

48. When quantitative factors are applicable, planning the engagement solely to detect individually material misstatements overlooks the fact that the aggregate of uncorrected and undetected individually immaterial misstatements may cause the subject matter information to be materially misstated. It may therefore be appropriate when planning the nature, timing and extent of procedures for the practitioner to determine a quantity less than materiality as a basis for determining the nature, timing and extent of procedures.

49. Materiality relates to the information covered by the assurance report. Therefore, when the engagement covers some, but not all, aspects of the information communicated about an underlying subject matter, materiality is considered in relation to only that portion that is covered by the engagement.

50. Concluding on the materiality of the misstatements identified as a result of the procedures performed requires professional judgment. For example, in a compliance engagement, the entity may have complied with nine provisions of the relevant law or regulation, but did not comply with one provision. Professional judgment is needed to conclude whether the entity complied with the relevant law or regulation as a whole. For example, the practitioner may consider the significance of the provision with which the entity did not comply, as well as the relationship of that provision to the remaining provisions of the relevant law or regulation.

Understanding the Underlying Subject Matter and Other Engagement Circumstances

51. The practitioner should make inquiries of the appropriate party(ies) regarding:
- (a) Whether they have knowledge of any actual, suspected or alleged intentional misstatement or non-compliance with laws and regulations affecting the subject matter information;
 - (b) Whether the responsible party has an internal audit function²⁸ and, if so, make further inquiries to obtain an understanding of the activities and main findings of the internal audit function with respect to the subject matter information; and
 - (c) Whether the responsible party has used any experts in the preparation of the subject matter information.

Limited Assurance	Reasonable Assurance
<p>52L. The practitioner should obtain an understanding of the underlying subject matter and other engagement circumstances sufficient to:</p> <ol style="list-style-type: none"> (a) Enable the practitioner to identify areas where a material misstatement of the subject matter information is likely to arise; and (b) Thereby, provide a basis for designing and performing procedures to address the areas identified in paragraph 52L(a) and to obtain limited assurance to support the practitioner's conclusion. 	<p>52R. The practitioner should obtain an understanding of the underlying subject matter and other engagement circumstances sufficient to:</p> <ol style="list-style-type: none"> (a) Enable the practitioner to identify and assess the risks of material misstatement²⁹ in the subject matter information; and (b) Thereby, provide a basis for designing and performing procedures to respond to the assessed risks and to obtain reasonable assurance to support the practitioner's opinion.
<p>53L. In obtaining an understanding of the underlying subject matter and other engagement circumstances under paragraph 52L, the practitioner should consider the process used to prepare the subject matter information.</p>	<p>53R. In obtaining an understanding of the underlying subject matter and other engagement circumstances under paragraph 52R, the practitioner should obtain an understanding of internal control over the preparation of the subject matter information relevant to the engagement. This includes evaluating the design of those controls relevant to the</p>

²⁸ For meaning of the term "Internal Audit Function", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

²⁹ For meaning of the term "Risk of Material Misstatement", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

III.462 Auditing Pronouncements

	engagement and determining whether they have been implemented by performing procedures in addition to the inquiry of the personnel responsible for the subject matter information.
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Obtaining Evidence

Risk Consideration and Responses to Risks

Limited Assurance	Reasonable Assurance
<p>54L. Based on the practitioner's understanding (see paragraph 52L), the practitioner should:</p> <ul style="list-style-type: none">(a) Identify areas where a material misstatement of the subject matter information is likely to arise;(b) Design and perform procedures to address the areas identified in paragraph 54L(a) and to obtain limited assurance to support the practitioner's conclusion.	<p>54R. Based on the practitioner's understanding (see paragraph 52R) the practitioner should:</p> <ul style="list-style-type: none">(a) Identify and assess the risks of material misstatement in the subject matter information; and(b) Design and perform procedures to respond to the assessed risks and to obtain reasonable assurance to support the practitioner's opinion. In addition to any other procedures on the subject matter information that are appropriate in the engagement circumstances, the practitioner's procedures would include obtaining sufficient appropriate evidence as to the operating effectiveness of relevant controls over the subject matter information when:<ul style="list-style-type: none">(i) The practitioner's assessment of the risks of material misstatement includes an expectation that controls are operating effectively, or(ii) Procedures other than testing of controls cannot alone provide sufficient appropriate evidence.
Determining Whether Additional Procedures are necessary in a Limited Assurance Engagement	Revision of Risk Assessment in a Reasonable Assurance Engagement
55L. If the practitioner becomes aware of a matter(s) that causes the practitioner to believe	55R. The practitioner's assessment of the risks of material misstatement in the subject

<p>that the subject matter information may be materially misstated, the practitioner should design and perform additional procedures to obtain further evidence until the practitioner is able to:</p> <p>(a) Conclude that the matter is not likely to cause the subject matter information to be materially misstated; or</p> <p>(b) Determine that the matter(s) causes the subject matter information to be materially misstated.</p>	<p>matter information may change during the course of the engagement as additional evidence is obtained. In circumstances where the practitioner obtains evidence which is inconsistent with the evidence on which the practitioner originally based the assessment of the risks of material misstatement, the practitioner should revise the assessment and modify the planned procedures accordingly.</p>
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56. When designing and performing procedures, the practitioner would also need to consider the relevance and reliability of the information to be used as evidence. If:

- (a) Evidence obtained from one source is inconsistent with that obtained from another; or
- (b) The practitioner has doubts about the reliability of information to be used as an evidence, the practitioner should determine what changes or additions to the procedures are necessary to resolve the matter, and should consider the effect of the matter, if any, on other aspects of the engagement.

57. The practitioner should accumulate uncorrected misstatements identified during the engagement other than those that are clearly trivial and determine the effect of the misstatement on the assurance report.

Work Performed by a Practitioner's Expert³⁰

58. When the work of a practitioner's expert is to be used, the practitioner should also:
- (a) Evaluate whether the practitioner's expert has the necessary competence, capabilities and objectivity for the practitioner's purposes. In the case of a practitioner's external expert, the evaluation of objectivity should include inquiry regarding interests and relationships that may create a threat to that expert's objectivity;
 - (b) Obtain a sufficient understanding of the field of expertise of the practitioner's expert;
 - (c) Agree with the practitioner's expert on the nature, scope and objectives of that expert's work; and
 - (d) Evaluate the adequacy of the practitioner's expert's work for the practitioner's purposes.

Work Performed by Another Practitioner, a Responsible Party's or Measurer's or Evaluator's Expert, or an Internal Auditor

³⁰ For meaning of the term "Practitioner's Expert", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

III.464 Auditing Pronouncements

59. When the work of another practitioner is to be used, the practitioner should evaluate whether that work is adequate for the practitioner's purposes.

60. If information to be used as evidence has been prepared using the work of a responsible party's or a measurer's or evaluator's expert, the practitioner should, to the extent necessary having regard to the significance of that expert's work for the practitioner's purposes:

- (a) Evaluate the competence, capabilities and objectivity of that expert;
- (b) Obtain an understanding of the work of that expert; and
- (c) Evaluate the appropriateness of that expert's work as evidence.

61. If the practitioner plans to use the work of the internal audit function, the practitioner should evaluate the following:

- (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;
- (b) The level of competence of the internal audit function;
- (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control; and
- (d) Whether the work of the internal audit function is adequate for the purposes of the engagement.

Written Representations

62. The practitioner should request from the appropriate party(ies) a written representation:

- (a) That it has provided the practitioner with all information of which the appropriate party(ies) is aware that is relevant to the engagement.
- (b) Confirming the measurement or evaluation of the underlying subject matter against the applicable criteria, including that all relevant matters are reflected in the subject matter information.

63. If, in addition to required representations, the practitioner determines that it is necessary to obtain one or more written representations to support other evidence relevant to the subject matter information, the practitioner should request such other written representations.

64. When written representations relate to matters that are material to the subject matter information, the practitioner should:

- (a) Evaluate their reasonableness and consistency with other evidence obtained, including other representations (oral or written); and

- (b) Consider whether those making the representations can be expected to be well-informed on the particular matters.
65. The date of the written representations should be as near as practicable to, but not after, the date of the assurance report.

Requested Written Representations Not Provided or Not Reliable

66. If one or more of the requested written representations are not provided or the practitioner concludes that there is sufficient doubt about the competence, integrity, ethical values, or diligence of those providing the written representations, or that the written representations are otherwise not reliable, the practitioner should:

- (a) Discuss the matter with the appropriate party(ies);
- (b) Re-evaluate the integrity of those from whom the representations were requested or received and evaluate the effect that this may have on the reliability of representations (oral or written) and evidence in general; and
- (c) Take appropriate actions, including determining the possible effect on the conclusion in the assurance report.

Subsequent Events

67. When relevant to the engagement, the practitioner should consider the effect on the subject matter information and on the assurance report of events up to the date of the assurance report, and should respond appropriately to the facts that become known to the practitioner after the date of the assurance report, that, had they been known to the practitioner at that date, may have caused the practitioner to amend the assurance report. The extent of consideration of subsequent events depends on the potential for such events to affect the subject matter information and to affect the appropriateness of the practitioner's conclusion. However, the practitioner has no responsibility to perform any procedures regarding the subject matter information after the date of the assurance report.

Other Information³¹

68. When documents containing the subject matter information and the assurance report thereon include other information, the practitioner should read that other information to identify material inconsistencies, if any, with the subject matter information or the assurance report and, if on reading that other information, the practitioner:

- (a) Identifies a material inconsistency between that other information and the subject matter information or the assurance report; or

³¹ For meaning of the term "Other Information", refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

- (b) Becomes aware of a material misstatement of fact³² in that other information that is unrelated to matters appearing in the subject matter information or the assurance report,

The practitioner should discuss the matter with the appropriate party(ies) and take further action as appropriate.

Description of Applicable Criteria

69. The practitioner would need to evaluate whether the subject matter information adequately refers to or describes the applicable criteria. The description of the applicable criteria advises intended users of the framework on which the subject matter information is based, and is particularly important when there are significant differences between various criteria regarding how particular matters may be treated in the subject matter information.

70. A description that the subject matter information is prepared in accordance with particular applicable criteria is appropriate only if the subject matter information complies with all relevant requirements of those applicable criteria that are effective. A description of the applicable criteria that contains imprecise qualifying or limiting language (for example, “the subject matter information is in substantial compliance with the requirements of XYZ”) is not an adequate description as it may mislead users of the subject matter information.

Forming the Assurance Opinion/Conclusion

71. The practitioner should evaluate the sufficiency and appropriateness of the evidence obtained in the context of the engagement and, if necessary in the circumstances, attempt to obtain further evidence. The practitioner should consider all relevant evidence, regardless of whether it appears to corroborate or to contradict the measurement or evaluation of the underlying subject matter against the applicable criteria. If the practitioner is unable to obtain necessary further evidence, the practitioner should consider the implications for the practitioner’s opinion/conclusion in paragraph 72³³.

72. The practitioner should form an opinion/a conclusion about whether the subject matter information is free of material misstatement. In forming that opinion/conclusion, the practitioner should consider the practitioner’s conclusion in paragraph 71 regarding the sufficiency and appropriateness of evidence obtained and an evaluation of whether uncorrected misstatements are material, individually or in the aggregate.

73. Evidence is necessary to support the practitioner’s opinion/conclusion and assurance report. It is cumulative in nature and is primarily obtained from procedures performed during the course of the engagement. It may, however, also include information obtained from other sources,

³²For meaning of the term “Misstatement of Fact”, refer the Glossary of Terms given in the Appendix 1 to the Guidance Note.

³³ Refer Para 41- 45 of the Framework for Assurance Engagements.

such as previous engagements (provided the practitioner has determined whether changes have occurred since the previous engagement that may affect its relevance to the current engagement) or the quality control procedures for client acceptance and continuance. Evidence may come from sources inside and outside the appropriate party(ies). Also, information that may be used as evidence may have been prepared by an expert employed or engaged by the appropriate party(ies). Evidence comprises both information that supports and corroborates aspects of the subject matter information, and any information that contradicts aspects of the subject matter information. In addition, in some cases, the absence of information (for example, refusal by the appropriate party(ies) to provide a requested representation) is used by the practitioner, and therefore, also constitutes evidence. Most of the practitioner's work in forming the assurance opinion/conclusion consists of obtaining and evaluating evidence.

74. If the practitioner is unable to obtain sufficient appropriate evidence, a scope limitation exists and the practitioner should express a qualified opinion/conclusion or disclaim an opinion/conclusion, or withdraw from the engagement, where withdrawal is possible under applicable law or regulation, as appropriate.

Preparing the Assurance Report

75. The assurance report should be in writing and should contain a clear expression of the practitioner's opinion/conclusion about the subject matter information. Where the subject matter information is made up of a number of aspects, separate opinions/conclusions may be provided on each aspect. All such separate opinions/conclusions do not need to relate to the same level of assurance. Rather, each conclusion is expressed in the form that is appropriate to either a reasonable assurance engagement or a limited assurance engagement. References in this Guidance Note to the opinion/conclusion in the assurance report include each opinion/conclusion when separate opinions/conclusions are provided.

76. The practitioner's opinion/conclusion should be clearly separated from information or explanations that are not intended to affect the practitioner's opinion/conclusion, including any Emphasis of Matter, Other Matter, findings related to particular aspects of the engagements, recommendations or additional information included in the assurance report. The wording used should make it clear that an Emphasis of Matter, Other Matter, findings, recommendations or additional information is not intended to detract from the practitioner's opinion/conclusion.

77. Oral and other forms of expressing conclusions can be misunderstood without the support of a written report. For this reason, the practitioner shall not report orally without providing a written assurance report.

78. This Guidance Note does not require a standardized format for reporting on all assurance engagements. Instead, it identifies the basic elements the assurance report is to include. Assurance reports are tailored to the specific engagement circumstances. The practitioner may use headings, paragraph numbers, typographical devices, for example the bolding of text, and other

mechanisms to enhance the clarity and readability of the assurance report.

79. The practitioner may choose a “short form” or “long form” style of reporting to facilitate effective communication to the intended users. “Short-form” reports ordinarily include only the basic elements. “Long-form” reports include other information and explanations that are not intended to affect the practitioner’s conclusion. In addition to the basic elements, long-form reports may describe in detail the terms of the engagement, the applicable criteria being used, findings relating to particular aspects of the engagement, details of the qualifications and experience of the practitioner and others involved with the engagement, disclosure of materiality levels, and, in some cases, recommendations. The practitioner may find it helpful to consider the significance of providing such information to the information needs of the intended users. As required by paragraph 76, additional information is clearly separated from the practitioner’s conclusion and phrased in such a manner so as make it clear that it is not intended to detract from that conclusion.

Assurance Report Content

80. In order to assert compliance with this Guidance Note, among other things, the assurance report should include at a minimum the following basic elements:

- (a) A *title* that clearly indicates the report is an independent assurance report. An appropriate title helps to identify the nature of the assurance report, and to distinguish it from reports issued by others, such as those who do not have to comply with the same ethical requirements as the practitioner. In case, the applicable law or regulation or the contractual arrangement entered by the entity specifies a title or phrases to identify the assurance report, the practitioner may use the title or phrases so prescribed.
- (b) An *addressee*. An addressee identifies the party or parties to whom the assurance report is directed. The assurance report is ordinarily addressed to the engaging party, but in some cases there may be other intended users.
- (c) An *identification or description of the level of assurance obtained by the practitioner, the subject matter information and, when appropriate, the underlying subject matter*. When the practitioner’s conclusion is phrased in terms of a statement made by the appropriate party, that statement should accompany the assurance report, be reproduced in the assurance report or be referenced therein to a source that is available to the intended users. Identification and description of the subject matter information and, when appropriate, the underlying subject matter may include, for example:
 - The point in time or period of time to which the measurement or evaluation of the underlying subject matter relates.
 - Where applicable, the name of the responsible party or component of the responsible party to which the underlying subject matter relates.

- An explanation of those characteristics of the underlying subject matter or the subject matter information of which the intended users should be aware, and how such characteristics may influence the precision of the measurement or evaluation of the underlying subject matter against the applicable criteria, or the persuasiveness of available evidence. For example:
 - The degree to which the subject matter information is qualitative versus quantitative, objective versus subjective, or historical versus prospective.
 - Changes in the underlying subject matter or other engagement circumstances that affect the comparability of the subject matter information from one period to the next.
- (d) *Identification of the applicable criteria.* The assurance report identifies the applicable criteria against which the underlying subject matter was measured or evaluated so that the intended users can understand the basis for the practitioner's opinion/conclusion. The assurance report may include the applicable criteria, or refer to them if they are included in the subject matter information or if they are otherwise available from a readily accessible source. It may be relevant in the circumstances, to disclose:
- The source of the applicable criteria, and whether or not the applicable criteria are embodied in law or regulation, or issued by authorized or recognized bodies of experts that follow a transparent due process, that is, whether they are established criteria in the context of the underlying subject matter (and if they are not, a description of why they are considered suitable).
 - Measurement or evaluation methods used when the applicable criteria allows for choice between a number of methods.
 - Any significant interpretations made in applying the applicable criteria in the engagement circumstances.
 - Whether there have been any changes in the measurement or evaluation methods used.
- (e) Where appropriate, a description of any *significant inherent limitations associated with the measurement or evaluation of the underlying subject matter against the applicable criteria.* While in some cases, inherent limitations can be expected to be well-understood by the intended users of an assurance report, in other cases it may be appropriate to make explicit reference to them in the assurance report. For example, in an assurance report related to the effectiveness of internal control, it may be appropriate to note that the historic evaluation of effectiveness is not relevant to future periods due to the risk that internal control may become inadequate because of changes in conditions, or that the

III.470 Auditing Pronouncements

degree of compliance with policies or procedures may deteriorate.

- (f) When the applicable criteria are designed for a specific purpose, a statement alerting readers to this fact and that, as a result, the subject matter information may not be suitable for another purpose. In some cases the applicable criteria used to measure or evaluate the underlying subject matter may be designed for a specific purpose. For example, a regulator may require certain entities to use particular applicable criteria designed for regulatory purposes. To avoid misunderstandings, the practitioner alerts readers of the assurance report to this fact and that therefore, the subject matter information may not be suitable for another purpose.

In addition to the alert as required in the preceding paragraph, the practitioner may consider it appropriate to indicate that the assurance report is intended solely for specific users. Depending on the engagement circumstances, for example, the law or regulation of the particular jurisdiction, this may be achieved by restricting the distribution or use of the assurance report. While an assurance report may be restricted in this way, the absence of a restriction regarding a particular user or purpose does not itself indicate that a legal responsibility is owed by the practitioner in relation to that user or for that purpose. Whether a legal responsibility is owed will depend on the legal circumstances of each case and the relevant jurisdiction.

- (g) *A statement to identify the responsible party and the measurer or evaluator if different, and to describe their responsibilities and the practitioner's responsibilities.* Identifying relative responsibilities informs the intended users that the responsible party is responsible for the underlying subject matter, that the measurer or evaluator is responsible for the measurement or evaluation of the underlying subject matter against the applicable criteria, and that the Practitioner's role is to independently express an opinion/conclusion about the subject matter information.
- (h) A statement that the engagement was performed in accordance with this Guidance Note.
- (i) A statement that the firm, of which the practitioner is a partner has applied SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.*
- (j) *A statement that the practitioner complies with the independence and other ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.* The following is an illustration of a statement in the assurance report regarding compliance with ethical requirements:

"We conducted our engagement in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. That Guidance Note requires that we comply with the ethical requirements of the

Code of Ethics issued by the Institute of Chartered Accountants of India.”

(k) *An informative summary of the work performed* as the basis for the practitioner’s opinion/conclusion. In the case of a limited assurance engagement, an appreciation of the nature, timing, and extent of procedures performed is essential to understanding the practitioner’s opinion/conclusion. In a limited assurance engagement, the summary of the work performed should state that:

- (i) The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement; and
- (ii) Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

It is important that the summary be written in an objective way that allows intended users to understand the work done as the basis for the practitioner’s opinion/conclusion. In most cases, this will not involve detailing the entire work plan, but on the other hand it is important for it not to be so summarized as to be ambiguous, nor written in a way that is overstated or embellished.

(l) The practitioner’s opinion/conclusion:

- (i) When appropriate, the opinion/conclusion should inform the intended users of the context in which the practitioner’s opinion/conclusion is to be read.

It may be appropriate to inform the intended users of the context in which the practitioner’s opinion/conclusion is to be read when the assurance report includes an explanation of particular characteristics of the underlying subject matter of which the intended users should be aware. The practitioner’s opinion/conclusion may, for example, include wording such as: “This opinion/conclusion has been formed on the basis of the matters outlined elsewhere in this independent assurance report.”

- (ii) In a reasonable assurance engagement, the opinion is expressed in a positive form. Examples of opinion expressed in a form appropriate for a reasonable assurance engagement include:

- When expressed in terms of the underlying subject matter and the applicable criteria, “In our opinion, the entity has complied, in all material respects, with XYZ law”;
- When expressed in terms of the subject matter information and the applicable criteria, “In our opinion, the Statement of Net Worth is

III.472 Auditing Pronouncements

properly prepared, in all material respects, based on XYZ criteria”; or

- When expressed in terms of a statement made by the appropriate party, “In our opinion, the [appropriate party’s] statement that the entity has complied with XYZ law is, in all material respects, fairly stated,” or “In our opinion, the [appropriate party’s] statement that the key performance indicators are presented in accordance with XYZ criteria is, in all material respects, fairly stated”.

(iii) In a limited assurance engagement, the conclusion is expressed in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner’s attention to cause the practitioner to believe that the subject matter information is materially misstated. Examples of conclusions expressed in a form appropriate for a limited assurance engagement include:

- When expressed in terms of the underlying subject matter and the applicable criteria, “Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that [the entity] has not complied, in all material respects, with XYZ law.”
- When expressed in terms of the subject matter information and the applicable criteria, “Based on the procedures performed and evidence obtained, we are not aware of any material amendments that need to be made to the assessment of key performance indicators for them to be in accordance with XYZ criteria.”; or
- When expressed in terms of a statement made by the appropriate party, “Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that the [appropriate party’s] statement that [the entity] has complied with XYZ law, is not, in all material respects, fairly stated.”

(iv) The opinion/conclusion in (ii) or (iii) should be phrased using appropriate words for the underlying subject matter and applicable criteria given the engagement circumstances and need to be phrased in terms of:

- a. The underlying subject matter and the applicable criteria;
- b. The subject matter information and the applicable criteria; or
- c. A statement made by the appropriate party.

Forms of expression which may be useful for underlying subject matters include,

for example, one, or a combination of, the following:

- For compliance engagements—“in compliance with” or “in accordance with.”
 - For engagements when the applicable criteria describe a process or methodology for the preparation or presentation of the subject matter information—“properly prepared.”
 - For engagement when the principles of fair presentation are embodied in the applicable criteria—“fairly stated.”
- (v) When the practitioner expresses a modified opinion/conclusion, the assurance report should contain:
- a. A section that provides a description of the matter(s) giving rise to the modification; and
 - b. A section that contains the practitioner’s modified opinion/conclusion
- (m) *The practitioner’s signature.* The assurance report is signed by the practitioner in his personal name. Where a Firm is appointed to carry out the engagement, the report is signed in the personal name of the practitioner and in the name of the audit firm. The partner/proprietor signing the assurance report also needs to mention the membership number assigned by the ICAI. They also include the registration number of the Firm, wherever applicable, as allotted by ICAI, in the assurance reports signed by them.
- (n) *The date of the assurance report.* The assurance report should be dated no earlier than the date on which the practitioner has obtained the evidence on which the practitioner’s opinion/conclusion is based, including evidence that those with the recognized authority have asserted that they have taken responsibility for the subject matter information.
- (o) The place of signature.

Reference to the Practitioner’s Expert in the Assurance Report

81. If the practitioner refers to the work of a practitioner’s expert in the assurance report, the wording of that report should not imply that the practitioner’s responsibility for the opinion/conclusion expressed in that report is reduced because of the involvement of that expert.

Assurance Report Prescribed by Law or Regulation

82. If the practitioner is required by law or regulation to use a specific layout or wording of the assurance report, the assurance report should refer to this Guidance Note, only if the assurance report includes, at a minimum, each of the elements identified in paragraph 80.

Unmodified and Modified Opinions/Conclusions

83. The practitioner should express an unmodified opinion/conclusion when the practitioner concludes:

- (a) In the case of a reasonable assurance engagement, that the subject matter information is prepared, in all material respects, in accordance with the applicable criteria; or
- (b) In the case of a limited assurance engagement, that, based on the procedures performed and evidence obtained, no matter(s) has come to the attention of the practitioner that causes the practitioner to believe that the subject matter information is not prepared, in all material respects, in accordance with the applicable criteria.

84. If the practitioner considers it necessary to:

- (a) Draw intended users' attention to a matter presented or disclosed in the subject matter information that, in the practitioner's judgment, is of such importance that it is fundamental to intended users' understanding of the subject matter information (an Emphasis of Matter paragraph); or
- (b) Communicate a matter other than those that are presented or disclosed in the subject matter information that, in the practitioner's judgment, is relevant to intended users' understanding of the engagement, the practitioner's responsibilities or the assurance report (an Other Matter paragraph),

and this is not prohibited by law or regulation, the practitioner may do so in a paragraph in the assurance report, with an appropriate heading, that clearly indicates the practitioner's opinion/conclusion is not modified in respect of the matter/s. In the case of an Emphasis of Matter paragraph, such a paragraph should refer only to the information presented or disclosed in the subject matter information.

85. The practitioner would need to express a modified opinion/conclusion in the following circumstances:

- (a) When, in the practitioner's professional judgment, a scope limitation exists and the effect of the matter could be material. In such cases, the practitioner should express a qualified opinion/conclusion or a disclaimer of opinion/conclusion.
- (b) When, in the practitioner's professional judgment, the subject matter information is materially misstated. In such cases, the practitioner should express a qualified opinion/conclusion or adverse opinion/conclusion.

Examples of qualified and adverse opinions/conclusions and a disclaimer of opinions/conclusion are:

- Qualified conclusion (an example for limited assurance engagements with a material misstatement) – “Based on the procedures performed and the evidence obtained, except for the effect of the matter described in the Basis for Qualified Conclusion section of our report, nothing has come to our attention that causes us to believe that the [appropriate party’s] statement does not present fairly, in all material respects, the entity’s compliance with XYZ law.”
- Adverse opinion (an example for a material and pervasive misstatement for both reasonable assurance and limited assurance engagements) – “Because of the significance of the matter described in the Basis for Adverse Opinion/Conclusion section of our report, the [appropriate party’s] statement does not present fairly the entity’s compliance with XYZ law.”
- Disclaimer of conclusion (an example for a material and pervasive limitation of scope for both reasonable assurance and limited assurance engagements) – “Because of the significance of the matter described in the Basis for Disclaimer of Opinion/Conclusion section of our report, we have not been able to obtain sufficient appropriate evidence to form an opinion/ conclusion on the [appropriate party’s] statement. Accordingly, we do not express an opinion/ conclusion on that statement.”

86. The practitioner should express a qualified opinion/conclusion when, in the practitioner’s professional judgment, the effects, or possible effects, of a matter are not so material and pervasive as to require an adverse opinion/conclusion or a disclaimer of opinion/conclusion. A qualified opinion/conclusion should be expressed as being “except for” the effects, or possible effects, of the matter to which the qualification relates.

87. The term ‘pervasive’ describes the effects on the subject matter information of misstatements or the possible effects on the subject matter information of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate evidence. Pervasive effects on the subject matter information are those that, in the practitioner’s professional judgment:

- (a) Are not confined to specific aspects of the subject matter information;
- (b) If so confined, represent or could represent a substantial proportion of the subject matter information; or
- (c) In relation to disclosures, are fundamental to the intended users’ understanding of the subject matter information.
- (d) The nature of the matter, and the practitioner’s judgment about the pervasiveness of the effects or possible effects on the subject matter information, affects the type of conclusion to be expressed.

88. If the practitioner expresses a modified opinion/conclusion because of a scope limitation

III.476 Auditing Pronouncements

but is also aware of a matter(s) that causes the subject matter information to be materially misstated, the practitioner should include in the assurance report a clear description of both the scope limitation and the matter(s) that causes the subject matter information to be materially misstated.

89. When the statement made by the appropriate party has identified and properly described that the subject matter information is materially misstated, the practitioner should either:

- (a) Express a qualified opinion/conclusion or adverse opinion/conclusion phrased in terms of the underlying subject matter and the applicable criteria; or
- (b) If specifically required by the terms of the engagement to phrase the opinion/conclusion in terms of a statement made by the appropriate party, express an unqualified opinion/conclusion but include an Emphasis of Matter paragraph in the assurance report, referring to the statement made by the appropriate party that identifies and properly describes that the subject matter information is materially misstated. In some cases, the measurer or evaluator may identify and properly describe that the subject matter information is materially misstated. For example, in a compliance engagement the measurer or evaluator may correctly describe the instances of non-compliance. In such circumstances, paragraph 88 requires the practitioner to draw the intended users' attention to the description of the material misstatement, by either expressing a qualified or adverse opinion/conclusion or by expressing an unqualified opinion/conclusion but emphasizing the matter by specifically referring to it in the assurance report.

90. **Appendix 2** to the Guidance Note contains illustrative formats of Reports/Certificates.

Other Communication Responsibilities

91. The practitioner should consider whether, pursuant to the terms of the engagement and other engagement circumstances, any matter has come to the attention of the practitioner that is to be communicated with the responsible party, the measurer or evaluator, the engaging party, those charged with governance or others.

Documentation

92. The practitioner should prepare on a timely basis engagement documentation that provides a record of the basis for the assurance report that is sufficient and appropriate to enable an experienced practitioner, having no previous connection with the engagement, to understand:

- (a) The nature, timing and extent of the procedures performed to comply with the Guidance Note and applicable legal and regulatory requirements;
- (b) The results of the procedures performed, and the evidence obtained; and
- (c) Significant matters arising during the engagement, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

93. If the practitioner identifies information that is inconsistent with the practitioner's final opinion/conclusion regarding a significant matter, the practitioner should document how the practitioner addressed the inconsistency.

94. The practitioner should assemble the engagement documentation in an engagement file and complete the administrative process of assembling the final engagement file on a timely basis after the date of the assurance report. SQC 1 requires establishment of policies and procedures for the timely completion of the assembly of engagement files. An appropriate time limit within which to complete the assembly of the final engagement file is ordinarily not more than 60 days after the date of the assurance report.

95. The completion of the assembly of the final engagement file after the date of the assurance report is an administrative process that does not involve the performance of new procedures or the drawing of new opinion/conclusions. Changes may, however, be made to the documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting evidence that the practitioner has obtained, discussed and agreed with the relevant practitioners of the engagement team before the date of the assurance report.

96. After the assembly of the final engagement file has been completed, the practitioner should not delete or discard engagement documentation of any nature before the end of its retention period. The retention period for assurance engagements ordinarily is no shorter than seven years from the date of assurance report.³⁴

97. If the practitioner finds it necessary to amend existing engagement documentation or add new engagement documentation after the assembly of the final engagement file has been completed the practitioner should, regardless of the nature of the amendments or additions, document:

- a) The specific reasons for making the amendments or additions; and
- b) When, and by whom, they were made and reviewed.

APPENDIX 1

³⁴ Refer Para 83 of SQC 1

Glossary of Terms Used in the Guidance Note

For purposes of this Guidance Note, the following terms have the meanings attributed below.

1. Assurance engagement—An engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express an opinion/conclusion, designed to enhance the degree of confidence of the intended users, other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria). Each assurance engagement is classified on two dimensions:

- Either a reasonable assurance engagement or a limited assurance engagement:
 - *Reasonable assurance engagement*—An assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for the practitioner’s opinion. The practitioner’s opinion is expressed in a form that conveys the practitioner’s opinion on the outcome of the measurement or evaluation of the underlying subject matter against the criteria.
 - *Limited assurance engagement*—An assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has(have) come to the practitioner’s attention to cause the practitioner to believe that the subject matter information is materially misstated. The nature, timing, and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner’s professional judgment, meaningful.
- Either assertion based engagement or a direct reporting engagement:
 - *Assertion based engagement*—An assurance engagement in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria. A party other than the practitioner also often presents the resulting subject matter information in a report or statement. In some cases, however, the subject matter information may be presented by the practitioner in the assurance report. In an attestation engagement, the practitioner’s conclusion addresses whether the subject matter information is free from material misstatement. The practitioner’s conclusion may be phrased in terms of:
 - (i) The underlying subject matter and the applicable criteria;
 - (ii) The subject matter information and the applicable criteria; or

- (iii) A statement made by the appropriate party.
 - *Direct reporting engagement*—An assurance engagement in which the practitioner measures or evaluates the underlying subject matter against the applicable criteria and the practitioner presents the resulting subject matter information as part of, or accompanying, the assurance report. In a direct engagement, the practitioner's conclusion addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria.
2. Assurance skills and techniques—Those planning, evidence gathering, evidence evaluation, communication and reporting skills and techniques demonstrated by an assurance practitioner that are distinct from expertise in the underlying subject matter of any particular assurance engagement or its measurement or evaluation. Assurance skill and techniques include:
- Application of professional skepticism and professional judgment;
 - Planning and performing an assurance engagement, including obtaining and evaluating evidence;
 - Understanding information systems and the role and limitations of internal control;
 - Linking the consideration of materiality and engagement risks to the nature, timing and extent of procedures;
 - Applying procedures as appropriate to the engagement (which may include inquiry, inspection, re-calculation, re-performance, observation, confirmation, and analytical procedures); and
 - Systematic documentation practices and assurance report-writing skills.
3. Criteria—The benchmarks used to measure or evaluate the underlying subject matter. The “applicable criteria” are the criteria used for the particular engagement. Suitable criteria are required for reasonably consistent measurement or evaluation of an underlying subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. The suitability of criteria is context-sensitive, that is, it is determined in the context of the engagement circumstances. Even for the same underlying subject matter there can be different criteria, which will yield a different measurement or evaluation. For example, a measurer or evaluator might select, as one of the criteria for the underlying subject matter of customer satisfaction, the number of customer complaints resolved to the acknowledged satisfaction of the customer; another measurer or evaluator might select the number of repeat purchases in the three months following the initial purchase. The suitability of criteria is not affected by the level of assurance, that is, if criteria are unsuitable for a reasonable assurance engagement, they are also unsuitable for a limited assurance engagement, and vice versa. Suitable criteria include, when relevant, criteria for presentation and disclosure.

III.480 Auditing Pronouncements

4. Engagement circumstances — The broad context defining the particular engagement, which includes the terms of the engagement; whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the underlying subject matter; the measurement or evaluation criteria; the information needs of the intended users; relevant characteristics of the responsible party, the measurer or evaluator, and the engaging party and their environment; and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.
5. Engagement partner — The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the assurance report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
6. Engagement risk — The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated³⁵.
7. Engaging party — The party(ies) that engages the practitioner to perform the assurance engagement. The engaging party may be under different circumstances, management or those charged with governance of the responsible party, a legislature, the intended users, the measurer or evaluator, or a different third party
8. Engagement team — All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
9. Evidence — Information used by the practitioner in arriving at the practitioner's conclusion. Evidence includes both, information contained in relevant information systems, if any, and other information
10. Firm — A sole practitioner/proprietor, partnership or any such entity of professional accountants, as may be permitted by law.
11. Historical financial information — Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
12. Internal audit function — A function of an entity that performs assurance and consulting activities, designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.
13. Intended users — The individual(s) or organization(s), or group(s) thereof that the practitioner expects will use the assurance report.

³⁵ Refer to Para 47-48 and Para 51 of the Framework for Assurance Engagements.

In some cases there may be intended users other than those to whom the assurance report is addressed. The practitioner may not be able to identify all those who will read the assurance report, particularly, where a large number of people have access to it. In such cases, particularly where possible, users are likely to have a broad range of interests in the underlying subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law or regulation.

Intended users or their representatives may be directly involved with the practitioner and the responsible party (and the engaging party, if different) in determining the requirements of the engagement. Regardless of the involvement of others however, and unlike an agreed-upon procedures engagement (which involves reporting factual findings based upon procedures agreed with the engaging party and any appropriate third parties, rather than a conclusion):

- (a) The practitioner is responsible for determining the nature, timing and extent of procedures; and
- (b) The practitioner may need to perform additional procedures, if information comes to the practitioner's attention that differs significantly from that on which the determination of planned procedures was based.

In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the appropriate party(ies) to arrange for an assurance engagement to be performed for a specific purpose. When engagements use criteria that are designed for a specific purpose, paragraph 80 requires a statement alerting readers to this fact. In addition, the practitioner may consider it appropriate to indicate that the assurance report is intended solely for specific users. Depending on the engagement circumstances, this may be achieved by restricting the distribution or use of the assurance report.

14. **Measurer or evaluator** — The party(ies) who measures or evaluates the underlying subject matter against the criteria. The measurer or evaluator possesses expertise in the underlying subject matter. In many attestation engagements, the responsible party may also be the measurer or evaluator, and the engaging party. The measurer or evaluator is responsible for having a reasonable basis for the subject matter information. What constitutes a reasonable basis will depend on the nature of the underlying subject matter and other engagement circumstances. In some cases, a formal process with extensive internal controls may be needed to provide the measurer or evaluator with a reasonable basis that the subject matter information is free from material misstatement. The fact that the practitioner will report on the subject matter information is not a substitute for the measurer or evaluator's own processes to have a reasonable basis for the subject matter information.

15. **Misstatement** — A difference between the subject matter information and the appropriate measurement or evaluation of the underlying subject matter in accordance with the criteria. Misstatements can be intentional or unintentional, qualitative or quantitative, and include

III.482 Auditing Pronouncements

omissions.

16. Misstatement of fact (with respect to other information)—Other information that is unrelated to matters appearing in the subject matter information or the assurance report that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing the subject matter information.

17. Other information — Information (other than the subject matter information and the assurance report thereon) which is included, either by law, regulation or custom, in a document containing the subject matter information and the assurance report thereon.

18. Practitioner's expert — An individual or organization possessing expertise in a field other than assurance, whose work in that field is used by the practitioner to assist the practitioner in obtaining sufficient appropriate evidence. A practitioner's expert may be either a practitioner's internal expert (who is a partner or staff, including temporary staff, of the practitioner's firm or a network firm), or a practitioner's external expert.

19. Professional judgment — The application of relevant training, knowledge and experience, within the context provided by assurance and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the engagement.

20. Professional skepticism — An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement, and a critical assessment of evidence.

21. Responsible party — The party(ies) responsible for the underlying subject matter. All assurance engagements have at least three parties: the responsible party, the practitioner, and the intended users. In many attestation engagements, the responsible party may also be the measurer or evaluator, and the engaging party.

22. Risk of material misstatement — The risk that the subject matter information is materially misstated prior to the engagement.

23. Subject matter information — The outcome of the measurement or evaluation of the underlying subject matter against the criteria, i.e., the information that results from applying the criteria to the underlying subject matter. In some cases, the subject matter information may be a statement that evaluates an aspect of a process, or of performance or compliance, in relation to the criteria. For example, "ABC's governance structure conformed with XYZ criteria during the period ..."

24. Underlying subject matter—The phenomenon that is measured or evaluated by applying criteria.

APPENDIX 2

Illustrative Formats of Reports/Certificates

Note: The illustrative formats of assurance reports or certificates for special purposes given in Appendix 2 should be tailored by the practitioner to meet the specific circumstances and requirements of the engagement.

Illustration 1: Practitioner's Report for Turnover/Net Worth/Net Profit/Working Capital/similar engagement pursuant to a Tender requirement

The Board of Directors
[Name of the Company]
[Company Address]

Independent Practitioner's Report on the Statement of [Annual Turnover for financial years ended.....and..... (specify periods); Current Assets; Current Liabilities; Computation of Working Capital and Computation of Net worth as at..... (specify date)]

1. This Report is issued in accordance with the terms of our engagement letter/agreement dated [specify date].
2. The accompanying Statement of Annual Turnover for financial years endedand..... (specify period) and the Statement of Current Assets; Current Liabilities; Working Capital and Net Worth as at (specify date) (hereinafter referred together as the "Statement") contains the details as required pursuant to compliance with the terms and conditions contained in [refer to the clause] of the Tender document issued by [refer to the authority] dated (specify date) with reference [specify the contract reference if available] (hereinafter referred to as the "Tender Document"), which we have initialled for identification purposes only.

Management's Responsibility for the Statement

3. The preparation of the Statement is the responsibility of the Management of [Name of the Company] (hereinafter the "Company") including the preparation and maintenance of all accounting and other relevant supporting records and documents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Statement and applying

III.484 Auditing Pronouncements

an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.

4. The Management is also responsible for ensuring that the Company complies with the requirements of the Tender Document and provides all relevant information to [Name of the authority].

Practitioner's Responsibility

5. Pursuant to the requirements of the Tender Document, it is our responsibility to provide a reasonable assurance whether:
 - i) the amounts in the Statement of Annual Turnover for the year ended (specify period) have been accurately extracted from the audited financial statements;
 - ii) the amounts in the Statement in respect of current assets and current liabilities that form part of the working capital computation have been accurately extracted from the audited financial statements for the year ended (specify the period) and the computation of working capital is arithmetically correct;
 - iii) the amounts in the Statement that form part of the Net Worth computation have been accurately extracted from the audited financial statements for the year ended; and [month][date][year] and the computation of net worth is arithmetically correct; and
 - iv) the computation of net worth and working capital is in accordance with the method of computation set out in the clause [] of the Tender Document.
6. The audited financial statements referred to in paragraph 5 above, have been audited by us, on which we issued an unmodified audit opinion vide our report(s) dated (specify dates) respectively. Our audits of these financial statements were conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
7. We conducted our examination of the Statement in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Opinion

9. Based on our examination, as above, we are of the opinion that:
- i) the amounts in the Statement in respect of Annual Turnover, Current assets and Current liabilities have been accurately extracted from the audited financial statements for the years ended [date] and [date];
 - ii) the amounts that form part of the working capital and net worth computation have been accurately extracted from the audited financial statements for the years ended[specify date] and [specify date]; and that the computation of working capital and net worth in the Statement is mathematically accurate and is in accordance with the method of computation set out in the clause [] of the Tender Document.

Restriction on Use

10. The certificate is addressed to and provided to the Board of Directors of the Company solely for the purpose to enable comply with requirement of Tender Document and to submit the accompanying Statement to [specify the authority], and should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care for any other purpose or to any other person to whom this certificate is shown or into whose hands it may come without our prior consent in writing.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Assurance Report)
(Designation³⁶)
Membership Number

Place of Signature
Date

³⁶ Partner or Proprietor, as the case may be.

Illustration 2: Auditor’s Annual Activity Certificate for Indian Branch Office/Liaison Office of Foreign Companies

The Authorised Representatives,
[Name of the Branch Office/Liaison Office]
[Address]

Independent Auditor’s Annual Activity Certificate for Indian Branch of [Name of the Foreign Company]

1. This Certificate is issued in accordance with the terms of our agreement dated [date].
2. [Name of the Indian Branch /Liaison Office], (the “Indian Branch”/ “Liaison Office/s”) with PAN No. [Insert PAN Number of the Branch /Liaison Office/s] of [Name of the Foreign Company] (UIN [Insert UIN]) was established to undertake certain activities specifically permitted by the Reserve Bank of India (the “RBI”) vide its approval letter/s No/s. [*] (the “letter/s”).

Authorised Representatives’ Responsibility

3. The Authorised Representatives of the Branch Office/Liaison Office are responsible for ensuring that the Indian Branch/ Liaison Office complies with the requirement of approval letter and for providing all relevant information to the RBI.

Auditor’s Responsibility

4. Pursuant to the requirements of the RBI Master Circular No. 7 dated July 02, 2012 (the “Circular”), our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records as to whether the Indian Branch/ Liaison Office/s has/ have undertaken only those activities that have been specifically permitted by the RBI and has/ have complied with the specified terms and conditions.
5. We audited the financial statements of [Name of the Indian Branch /Liaison Office] as of and for the financial year ended 31 March XXXX, on which we issued an unmodified audit opinion vide our reports dated (specify date). Our audits of these financial statements were conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
6. We conducted our examination of the Statement in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

7. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Opinion

8. Based on our audit of financial statements for the year ended 31 March 20XX and the information and explanations given to us, we are of the opinion that the [Name of the Branch /Liaison Office/s] has/ have³⁷ undertaken only those activities during the period from [month] [date], [year] to [month] [date] that have been specifically permitted by the Reserve Bank of India, vide its approval letter/s³⁸ No/s³⁹ [] dated [month][date], [year] and has/have⁴⁰ complied with the terms and conditions specified in the above mentioned letter/s.

Restriction on Use

9. This certificate has been prepared at the request of the [Name of the Branch Office/Liaison Office] solely with reference to the Circular, as amended from time to time. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Assurance Report)
(Designation⁴¹)
Membership Number

Place of Signature

Date

³⁷ As Applicable

³⁸ As Applicable

³⁹ As Applicable

⁴⁰ As Applicable

⁴¹ Partner or Proprietor, as the case may be.

Illustration 3: Auditor’s Report on the Manner of Utilization of Funds required under Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015

The Board of Directors

[Name of the Company]

[Company Address]

Independent Auditor’s Report on the manner of utilization of the funds including for purposes other than those stated in the offer document

1. This report is issued in accordance with the terms of our agreement dated [●].
2. The accompanying Statement contains details of manner of the utilization of funds including funds utilized for purposes other than those stated in the offer document for the Rights Issue (the “Statement”), as required by the Clause 32(5) of Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, by the [Name of the Company] (the “Company”), which we have initialled for identification purposes only. The Funds were raised by the Company pursuant to the rights issue of [*] equity shares of face value of Rs. [] each, at a premium of Rs. [*] each, aggregating to Rs. [*].

Managements’ Responsibility for the Statement

3. The preparation of the accompanying Statement is the responsibility of the Management of the Company. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the Company complies with the requirements of the Equity Listing Agreement and for providing all relevant information to the Securities and Exchange Board of India.

Auditor’s Responsibility

5. Pursuant to the requirements of the Equity Listing Agreement, it is our responsibility to obtain reasonable assurance and form an opinion as to whether the Statement is in agreement with the [audited financial statements for the year ended [and books and records]⁴² of the Company].⁴³
6. The financial statements referred to in paragraph 5 above, have been audited by us on which we issued an unmodified audit opinion vide our reports dated [month][date][year]. Our audits of

⁴² Strike off, if not applicable

⁴³ If the audited financial statements of the entity are not available, it may not be possible for the practitioner to provide reasonable assurance on the utilization of funds by the entity. However, in case the practitioner is required to issue a report, the practitioner should consider providing a limited assurance report. Reference should be made to paragraph 80 of this Guidance Note, which specifies the requirements to be complied with by the while preparing an assurance report that expresses a limited assurance.

these financial statements were conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits were not planned and performed in connection with any transactions to identify matters that may be of potential interest to third parties.

7. We conducted our examination of the Statement in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.
8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Opinion

9. Based on our examination as above, and the information and explanations given to us, in our opinion, the Statement is in agreement with the audited financial statements for the year ended of the Company and fairly presents, in all material respects, the manner of the utilization of funds including funds utilized for purposes other than those stated in the offer document.

Restriction on Use

10. This report is addressed to and provided to the Board of Directors of the Company solely for the purpose of enabling it to comply with its obligations under the Equity Listing Agreement to submit the accompanying Statement to the Audit Committee accompanied by a report thereon from the statutory auditors and should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care for any other purpose or to any other person to whom this report is shown or into whose hands it may come without our prior consent in writing.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Assurance Report)
(Designation⁴⁴)
Membership Number

Place of Signature

Date

⁴⁴ Partner or Proprietor, as the case may be.

Illustration 4: Practitioner's Report on Statement of Fixed Assets for the Last Two Years in Respect of One of the Project of an Entity

The Board of Directors

[Name of the Company]

[Company Address]

Independent Practitioner's Report on Statement of Fixed Assets

1. This report is issued in accordance with the terms of our agreement dated [date].
2. The accompanying Schedule of Fixed Assets as at [date] and [date] has been prepared by M/s xxx (the "Company") in respect of its project at [ABC] (the "Statement"), pursuant to the requirement of 'Annexure B' of the application filed by the Company with the (specify the name of the relevant authority) for availing Fixed Capital Investment Subsidy relating to the new plant commissioned at xxx. We have initialled the Statement for identification purposes only.

Management's Responsibility

3. The accompanying Statement, including the creation and maintenance of all accounting and other records supporting its contents, is solely the responsibility of the Management of the Company. The Company's Management is responsible for the designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Company's Management is also responsible for ensuring that the Company complies with the requirements of the Scheme and for providing all relevant information to the (name of the authority).

Practitioner's Responsibility

5. It is our responsibility to report on the Statement based on our examination of the matters in the Statement with reference to the books of account and other records of the Company for the years ended [dates], which have been subjected to audit pursuant to the requirements of the Companies Act, 2013.
6. The financial statements for the financial years ended [dates], have been audited by us on which we issued an unmodified audit opinion *vide* our reports dated [month][date][year]. Our audits of these financial statements were conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material

misstatement. Our audits were not planned and performed in connection with any transactions to identify matters that may be of potential interest to third parties.

7. We conducted our examination of the Statement in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.
8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Opinion

9. Based on our examination, as above, and the information and explanations given to us, we report that the Statement is in agreement with the books of account and other records of the Company as produced to us for our examination.

Restriction on Use

10. This report has been issued at the request of the Board of Directors of the Company, for submission to _____ (name of the authority) pursuant to the requirements of the Scheme. Our report should not to be used for any other purpose or by any person other than the addressees of this report. Accordingly, we do not accept or assume any liability or duty of care for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Assurance Report)
(Designation⁴⁵)
Membership Number

Place of Signature
Date

⁴⁵ Partner or Proprietor, as the case may be.

GUIDANCE NOTE ON REPORTING UNDER SECTION 143(3)(f) AND (h) OF THE COMPANIES

Introduction

1. Section 143 of the Companies Act, 2013 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 143(1) of the Act requires the auditor to make certain specific enquiries during the course of the audit. Section 143(2) of the Act requires the auditor to, *inter alia*, give his report to the members of company on the accounts examined by him, and on every financial statement which are laid before the company in a general meeting. Sub-section (3) of section 143 of the Act also lays down certain matters required to be reported upon by the auditor in his report. Sub-section (3) of section 143 of Act provides as follows:

"(3) The auditor's report shall also state -

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
- (j) such other matters as may be prescribed.¹

Scope of the Guidance Note

2. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) of the said sub-section creates a requirement for the auditor to consider observations or comments of the auditor on financial transactions or matters which have an adverse effect on the functioning of the company. Such observations or comments would ordinarily lead to the modification of or an emphasis of matter in the auditor's report on financial statements. It may be noted that the matters that lead to modification in the auditor's report on financial statements are matters that give rise to a qualified opinion, adverse opinion or a disclaimer of opinion². Further, matters that lead to an emphasis of matter paragraphs are matters appropriately presented or disclosed in the financial statements that, in the auditor's judgement, are of such importance that they are fundamental to the users' understanding of the financial statements³. If the matter leading to the modification of the auditor's opinion or an emphasis of matter in the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to report such matter. Under clause (h) of sub-section (3) of section 143 of the Act, the auditor is required to state whether any matter leading to a qualification, reservation or adverse remark, that is, effectively the modification of the auditor's report on financial statements, relates to the maintenance of accounts and other matters connected therewith.

Reporting under Section 143(3)(f) of the Act

3. The relevant extracts of section 143(3)(f) of the Act are reproduced below:

“(3). The auditor's report shall also state –

.....

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;”
4. Clause (f) requires the auditor to report "the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company". An auditor's report may contain matters leading to modifications to the auditor's opinion or emphasis of matter in the auditor's report on the financial statements.

¹ Refer Rule 11 of Companies (Audit and Auditors) Rules, 2014.

² Reference may be made to Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report."

³ Reference may be made to paragraphs 6 and 7 of Standard on Auditing (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report."

III.494 Auditing Pronouncements

Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words “observations” or “comments” as appearing in clause (f) of section 143(3) are construed to have the same meaning as referring to “emphasis of matter paragraphs, situations leading to modification in the auditor’s report. Accordingly, the auditor should have made an “observation” or “comment” in the auditor’s report in order to determine the need to report under clause (f) of section 143(3). Therefore, only such “observations” or “comments” of the auditors on financial transactions or matters that have been made by the auditor in the auditor’s report which have an adverse effect on the functioning of the company are required to be reported under this clause. For the sake of clarity, it may be noted that neither the auditor’s observations nor the comments made by him have any adverse effect on the functioning of a company. These observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.

5. The Act does not specify the meaning of the phrase ‘adverse effect on the functioning of the company’. The expression should not be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, where such product that does not have any material contribution to the revenues of the company, etc. Such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit stipulated under the Act. A more logical and harmonious interpretation is that this reporting requirement does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.
6. The scope of the audit and auditor’s role remains as contemplated under the Standards on Auditing (SAs) and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200, *Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Standards of Auditing*, specifies that the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form the opinion of the true and fair view of the financial position and operating result of an enterprise. The auditor’s opinion, therefore, does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. SAs require auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high

level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. At this juncture, it may also be noted that SA 200 also clearly states that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

7. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (f) in sub-section (3) of section 143 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate the subject matters leading to modification of the audit report or emphasis of matter in the auditor's report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters which, in the opinion of the auditor, have an adverse effect on the functioning of the company should be reported under this clause. Conversely, such qualifications or adverse opinions or disclaimer of opinion or emphasis of matters of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be reported under this clause.
8. As far as inquiries under section 143(1) are concerned, the auditor is not required to report on these matters unless he has any comments to make on any of the items referred to therein. If the auditor has any comments or observations on any of the matters stated in section 143(1), the auditor should consider such comments or observations when reporting under this clause if they contain matters that may have any adverse effect on the functioning of the company.
9. Auditor's will need to apply professional judgement in considering matters of emphasis that may have an adverse effect on the functioning of the company. Ordinarily matters that are pervasive in nature such as going concern or matters that will significantly impact the operations of the company due to its size and nature will need to be reported under clause (f) of sub-section (3) of section 143 of the Act. Examples of emphasis of matter which may have an adverse effect on the functioning of the company include situations where:
 - the going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company's ability to continue as a going concern; or

III.496 Auditing Pronouncements

- a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.

Examples of emphasis of matter which may not have an adverse effect on the functioning of the company include a situation where there is an emphasis of matter:

- on managerial remuneration which is subject to the approval of the Central Government;
 - relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;
 - on frauds that have been dealt with in the financial statements of the company and would not have any continuing effect on the financial statements.
10. Another issue which arises is whether any observations or comments made by the auditor under clause (i) of section 143(3) in respect of the company's internal financial controls over financial reporting, which may have any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that reporting under section 143(3)(i) is part of the auditor's report though it may be reported in an annexure to the auditor's report. Accordingly, if any observations or comments made by the auditor on the adequacy or operating effectiveness of internal financial controls over financial reporting contain such matters, which, in his opinion, may have any adverse effect on the functioning of the company, should also be reported under clause (f) of section 143(3) even if such observation did not result in a modification to the audit opinion on the financial statements of the company. An example in this regard may be where an auditor reports that the company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification.

Reporting under Section 143(3)(h) of the Act

11. The relevant extracts of section 143(3)(h) of the Act are reproduced below:

“(3). The auditor's report shall also state –

.....

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;”

12. Clause (h) requires the auditor to report "any qualification, reservation or adverse remark" relating to the maintenance of accounts and other matters connected therewith. An auditor's report may contain matters leading to modifications in the auditor's report on financial statements. The matters that cause such modification may have a consequential effects or possible effects on the books of account maintained by the company and other matters connected therewith.
13. Section 128 of the Act, *inter alia*, states that every company shall prepare and keep its

books of account and other relevant books and papers and financial statements that give a true and fair view of the state of affairs of the company. Section 129(1) of the Act, *inter alia*, states that the financial statements shall comply with the accounting standards notified under section 133 of the Act. Section 2(13) of the Act defines “books of account” to include records maintained in respect of—

- (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
- (ii) all sales and purchases of goods and services by the company;
- (iii) the assets and liabilities of the company; and
- (iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section;

Clause (b) of section 143(3) requires the auditor to, *inter alia*, state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books.

14. Matters to be reported under clause (h) of section 143(3) needs to be evaluated based on the financial statements prepared under the Act. This is also consistent with the other reporting responsibilities of the auditor on books of account and compliance with notified/specified accounting standards that are reported by him under section 143(3). Accordingly, reporting under this clause is determined based on the financial statements prepared i.e., as at the balance sheet date.
15. The words “qualification”, “adverse remark” and “reservation” used in clause (h) of section 143(3) should be considered to be similar to the terms “qualified opinion”, “adverse opinion” and “disclaimer of opinion”, respectively, referred to in SA 705 “Modifications to the Opinion in the Independent Auditor’s Report”.
16. Accordingly, the auditor would need to report under clause (h) of section 143(3) any matter that causes a qualification, adverse remark or disclaimer of opinion on the financial statements since such matters will or possibly will have an effect on the books of account maintained by the company.
17. Further, reporting under clause (h) of section 143(3) will be required if the auditor makes any observation under clause (b) of section 143(3) relating to whether proper books of account as required by law have been kept by the company. For example, the auditor may have made an observation on maintenance of cost records under clause (b) of section 143(3) and this may not have had an effect on the financial statements of the company or the auditor’s opinion on the financial statements.
18. As a corollary, reporting under clause (h) of section 143(3) will not be required if there are no modifications, i.e., no qualified, adverse or disclaimer of opinion, and there are no such observations under clause (b) of section 143(3) regarding books of account kept by the company.

III.498 Auditing Pronouncements

19. Since clause (h) of section 143(3) requires the auditor to report under this clause only if the auditor has "any qualification, reservation or adverse remark", it is appropriate to conclude that a matter reported under emphasis of matter paragraph in the audit report need not be considered for reporting under this clause as an emphasis of matter is not in the nature of a qualification, reservation (disclaimer) or adverse remark.
20. Any material weakness in internal financial controls that is reported by the auditor under clause (i) of section 143(3) may not have an impact on the maintenance of books of account if such material weakness did not result in a modification to the opinion on the financial statements of the company. However, if the material weakness in internal financial controls resulted in a modification to the audit opinion on the financial statements, then such modification may be covered for reporting under clause (h) of section 143(3) as stated in paragraph 17 above.
21. The Appendix to this Guidance Note contains illustrations on matters that may give rise to reporting under section 143(3)(f) and/or section 143(3)(h) of the Companies Act, 2013.

APPENDIX

Illustrative Matters Forming Basis For Modified Opinion Or Emphasis Of Matter Paragraph in the Auditor's Report and Requiring Reporting Under Section 143(3)(f) and/or Section 143(3)(h) of the Companies Act, 2013

ILLUSTRATION 1

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at Rs. XXX (*As at 31st March 20YY: Rs. YYY*). The Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standard - 2 "Valuation of Inventories". The Company's records indicate that had the Management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX (*As at 31st March 20YY: Rs. YYY*) would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX (*Previous year ended 31st March, 20YY: Rs. YYY*), and income tax, profit for the year and shareholders' funds would have been reduced by Rs. X, Rs. XX and Rs. XXX, respectively (*Previous year ended 31st March, 20YY: Rs. Y, Rs. YY and Rs. YYY, respectively*). This matter was also qualified in our report/ the report of the predecessor auditors on the financial statements for the year ended 31st March 20YY.⁴

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph above, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

.....

.....

Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;

⁴ Where applicable and only in such case, disclosure of previous year figures is required - Attention of the readers is drawn to the provisions of Standard on Auditing (SA) 710, *Comparative Information—Corresponding Figures And Comparative Financial Statements* .

III.500 Auditing Pronouncements

.....
.....
(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....
.....
(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.”

ILLUSTRATION 2#

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

Emphasis of Matters

We draw attention to the following matters in the Notes to the financial statements:

a) Note X to the financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.

b) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully / substantially eroded, the Company has incurred a net loss/net cash loss during the current and previous year(s) and, the Company's current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

.....
(f) The going concern matter described in sub-paragraph (b) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

In this case there is nothing reportable under sec 143(3)(h).

ILLUSTRATION 3**Basis for Qualified Opinion**

ABC Company Limited's investment in XYZ Company, a foreign associate whose net worth has been fully/substantially eroded, is carried at Rs. XXX in the Balance Sheet as at March 31, 20XX. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects⁵ of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March 20XX, and its profit/loss and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....

(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.

ILLUSTRATION 4**Basis for Adverse Opinion**

The Company's financing arrangements expired and the amount outstanding was payable on March 31, 20XX. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and, therefore, it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

⁵ Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013 in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

.....
Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....
(f) The matter described in the Basis for Adverse Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....
(h) The adverse remarks relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Adverse Opinion paragraph above.

ILLUSTRATION 5

Basis for Disclaimer of Opinion

We were appointed as auditors of the Company after March 31, 20X1 and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at Rs. XXX and Rs. XXX, respectively.

In addition, the introduction of a new computerised accounts receivable system in September 20X0 resulted in numerous errors in accounts receivable. As of the date of our audit report, Management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of Rs. XXX as at March 31, 20X1.

As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable in the Balance Sheet, and the corresponding elements making up the Statement of Profit and Loss and Cash Flow Statement.

Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....

.....

(f) The matter described in the Basis for Disclaimer of Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The reservation relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Disclaimer of Opinion paragraph above.

Guidance Note on Audit of Consolidated Financial Statements (Revised 2016)

Introduction

1. The Council of the Institute of Chartered Accountants of India had issued Accounting Standard (AS) 21 'Consolidated Financial Statements' which was subsequently notified as a part of the Companies (Accounting Standards) Rules, 2006 by the Ministry of Corporate Affairs and subsequently amended vide the Companies (Accounting Standards) Amendment Rules, 2016. Also Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements' has been issued as a part of the Companies (Indian Accounting Standards) Rules, 2015 by the Ministry of Corporate Affairs. AS 21 and Ind AS 110 lay down principles and procedures for preparation and presentation of consolidated financial statements under AS and Ind AS respectively¹. In other words, whenever a parent decides to or is required to prepare and present consolidated financial statements, it should do so in accordance with the requirements of applicable Accounting Standards² under the relevant financial reporting framework. This Guidance Note does not provide guidance in relation to amalgamation/business combination.

2. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, consolidated cash flow statement, a consolidated statement of change in equity (if applicable) and any explanatory notes annexed to, or forming part thereof. Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements. The formats for preparation of balance sheet, statement of profit and loss and a statement of change in equity (if applicable) are prescribed under the Schedule III of the Companies Act, 2013.

¹ MCA has issued a road map for convergence with Ind AS. Those companies which are required to follow Ind AS will prepare their consolidated financial statements as per Ind AS 110 on Consolidated Financial Statements. Companies which are not covered by Ind AS road map and don't voluntarily elect to follow Ind AS are required to follow AS 21 on Consolidated Financial Statements notified under Companies (Accounting Standards) Rules, 2006 as amended upto date (recently AS 21 has been amended as per Notification No. G.S.R. 364(E) dated March 30, 2016). It may also be noted that Section 129 of the Companies Act, 2013 now mandates preparation of consolidated financial statements by all companies having subsidiaries and/associates and /joint ventures or joint operations. Similarly, paragraph 9 of AS 21(Revised) requires enterprises which do not have a subsidiary but have an associate and/or a joint venture to also prepare consolidated financial statements in accordance with AS 23 and AS 27 respectively.

For non-corporate entities, accounting standards issued by ICAI are applicable.

² For Companies covered by Ind AS, the relevant accounting standards are Ind AS 27 – Separate Financial Statements, Ind AS 28 – Investments in Associates and Joint Ventures, Ind AS 110 – Consolidated Financial Statements, Ind AS 111 – Joint Arrangements and Ind AS 112 – Disclosure of Interest in Other Entities, notified under the Companies (Indian Accounting Standards) Rules, 2015. For Companies not covered by Ind AS, the relevant accounting standards are AS 21 - Consolidated Financial Statements, AS 23 – Accounting for Investments in Associates in Consolidated Financial Statements and AS 27 – Financial Reporting of Interests in Joint Ventures, notified under the Companies (Accounting Standards) Rules, 2006. For non-corporate entities, the relevant accounting standards are AS 21, 23 and 27 issued by ICAI.

3. An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or *suo motu*, might be required to or otherwise engage the auditor for conducting the audit of consolidated financial statements. However, a law or regulation governing the entity may require the consolidated financial statements to be audited by the statutory auditor of the entity. This Guidance Note provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements. This Guidance Note can also be used while auditing consolidated financial statements prepared for special purpose, to the extent applicable.

4. This Guidance Note does not deal with accounting matters arising on consolidation of financial statements.

Definitions

5. Various terms used in this Guidance Note, have the same meaning as defined in applicable accounting standards. The same have been given in **Appendix II** to the Guidance Note.

Responsibility of Parent

6. The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:

- (a) identifying components, and including the financial information of the components to be included in the consolidated financial statements;
- (b) where appropriate, identifying reportable segments for segment reporting;
- (c) identifying related parties and related party transactions for reporting;
- (d) obtaining accurate and complete financial information from components;
- (e) making appropriate consolidation adjustments.
- (f) harmonization of accounting policies and accounting framework; and.
- (g) GAAP conversion, where applicable.

7. Apart from the above, the parent ordinarily issues instructions to the management of the components specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

Responsibility of the Auditor of the Consolidated Financial Statements

8. Section 129(4) of the Companies Act, 2013 requires that the provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding

company shall, *mutatis mutandis*, apply to the consolidated financial statements. Besides other matters, the principal auditor of the consolidated financial statements is responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects, in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements in addition to reporting on the additional matters as required under the Companies Act, 2013 and any other statute to the extent applicable.

9. Therefore, the auditor's objectives in an audit of consolidated financial statements are:

- (a) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of applicable financial reporting framework;
- (b) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements.
- (c) to enquire into the matters as specified in section 143(1) of the Companies Act, 2013; and.
- (d) to report on the matters given in the clauses (a) to (i) of section 143(3) of the Companies Act, 2013; for other matters under section 143(3)(j) read with rule 11 of the Companies (Audit and Auditors) Rules, 2014, to comment on the matters specified in sub-rule (a),(b) and (c)³ to the extent applicable.

10. Standards on Auditing⁴, Statements and Guidance Notes on auditing issued by the Institute of Chartered Accountants of India apply in the same manner to audit of consolidated financial statements as they apply to audit of separate financial statements. It means that the auditors, while conducting the audit of consolidated financial statements are, *inter alia*, expected to:

- (a) plan their work to enable them to conduct an effective audit in an efficient and timely manner;
- (b) obtain an understanding of the accounting and internal control systems including IT system like consolidation tool, sufficient to plan the audit and determine the nature, timing and extent of his audit procedures. Such an understanding would help the auditors to develop an effective audit approach;
- (c) use professional judgment to assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptable level; etc.

³ The auditor of the consolidated financial statements generally report on the matters pertaining to the component, on the basis of auditors' report of the respective component.

⁴ As specified under the Companies Act, 2013.

Audit Considerations

11. The following features of consolidated financial statements have an impact on the related audit procedures:

- (a) The consolidated financial statements are prepared on the basis of separate financial statements of the parent and its components, using the consolidation procedures prescribed by Accounting Standards⁵ under applicable financial reporting framework; and
- (b) The auditor of the consolidated financial statements may use the work of other auditors as per requirement of Standards on Auditing unless the auditor of consolidated financial statements is also the auditor of the other components of the group.

12. The consolidated financial statements (including the intermediate consolidated financial statements prepared internally)⁶ are prepared using the separate financial statements of the parent and its components and also other financial information, which might not be covered by the separate financial statements of these entities. The 'other financial information' would include disclosures to be made in the consolidated financial statements about the components, proportion of items included in the consolidated financial statements to which different accounting policies have been applied where permitted, adjustments made for the effects of significant transactions or other events that occur between the financial statements of parent and its components, as the case may be, etc. Thus, this 'other financial information' would be required to be additionally disclosed.

13. When an auditor accepts the audit of consolidated financial statements, the auditor should assess whether based on his work alone he would be able to express an opinion on the true and fair view presented by the consolidated financial statements. If the auditor is of the view that his own participation may not be enough or sufficient, he should consider using the work of 'other auditors'.

14. Such 'other auditors' might be the statutory auditors of the separate financial statements of one or more of the components or the auditors appointed specifically for assisting the auditor of the consolidated financial statements (the principal auditor).

15. Where the statutory auditors of one or more of the components of the parent are also requested to assist the principal auditor, the work to be performed by such statutory auditors

⁵ Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS) 23- Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) - 27, Financial Reporting of Interests in Joint Ventures OR Indian Accounting Standard (Ind AS) 110 – Consolidated Financial Statements, Indian Accounting Standard (Ind AS) 111- Joint Arrangements, Indian Accounting Standard (Ind AS) 112 –Disclosure of Interests in Other Entities and Indian Accounting Standard (Ind AS) 28 – Investments in Associates and Joint Ventures.

⁶ Intermediate consolidated financial statements are the consolidated financial statements of an intermediate parent, e.g., Company A has one subsidiary Company B. Company B has a subsidiary Company C. In this case, Company B is the intermediate parent and the consolidated financial statements prepared by Company B will be intermediate consolidated financial statements.

for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory audit of the respective component.

16. Standard on Auditing (SA) 600, 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity (Paragraph 2 of SA 600). The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, should comply with the requirements of SA 600.

17. In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

- The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS. (Refer paragraph 27 and 30 of this Guidance Note).
- The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable⁷.
- However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the concept of materiality would not be considered. Thus, the component auditor's observations, if any, on the component's financial statements, irrespective of whether the auditors of the component are also the auditors of the CFS or not, are required to be included in the parent auditor's report on the CFS, regardless of materiality. (Refer paragraph 46 of this Guidance Note)

Auditing the Consolidation

18. Before commencing an audit of consolidated financial statements, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. The auditor should make plans, among other things, for the following:

⁷ Refer ICAI's Announcement on the Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s) issued in February 2014.

- (a) Understanding of the group structure and group-wide controls⁸ including assessment of Information Technology (IT) system and related general and applications IT related controls (manual and automated) for consolidation process;
- (b) understanding of accounting policies of the parent and its components as well as of the consolidation process including the process of translation of financial statements of foreign components;
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed based on the assessment of the risk of material misstatement in the consolidation process;
- (d) determining the extent of use of other auditor's work in the audit; and
- (e) coordinating the work to be performed.

19. A parent which presents consolidated financial statements is required to consolidate all its components in the consolidated financial statements other than those for which exceptions have been provided in the relevant accounting standards under the applicable financial reporting framework.

20. The auditor should obtain a listing of all the components included in the consolidated financial statements and review the information provided by the management of the parent identifying the components. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion as referred to in paragraph 19 above. In respect of completeness of this information, the auditor should perform the following procedures:

- (a) review his working papers for the prior years for the known components;
- (b) review the parent's procedures for identification of various components;
- (c) make inquiries of management to identify any new components or any component which goes out of consolidated financial statements.

⁸ Group-wide controls may include a combination of the following:

- a. group management's risk assessment process, that is, the process for identifying, analysing and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements
- b. monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances at group level
- c. a process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components
- d. a central IT system controlled by the same general IT controls for all or part of the group
- e. control activities within an IT system that is common for all or some components
- f. monitoring of controls, including activities of the internal audit function and self-assessment programs
- g. consistent policies and procedures, including a group financial reporting procedures manual
- h. group-wide programs, such as codes of conduct and fraud prevention programs, and
- i. arrangements for assigning authority and responsibility to component management.

III.510 Auditing Pronouncements

- (d) review the investments of parent as well as its components to determine the shareholding in other entities;
- (e) review the joint ventures and joint arrangements as applicable;
- (f) review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group.
- (g) review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013.
- (h) also identify the changes in the shareholding that might have taken place during the reporting period.

21. The auditor should document procedures performed for assessing completeness of the components to be consolidated.

22. There would be various means by which control, joint control or significant influence can be obtained. In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know how, enforcement of statute, as the case may be, etc. The auditor may also review the minutes of the meetings of the Board of Directors subsequent to the year-end to understand if there has been any liquidation of investments or any further investments have been made as these may provide further evidence to understand if the control was meant to be temporary in nature or otherwise.

23. Where a component is excluded from the consolidated financial statements, the auditor should examine the reasons for exclusion and whether such exclusion is in conformity with the applicable financial reporting framework, for example, under the Companies (Accounting Standards) Rules, 2006, there could be two reasons for exclusion of a subsidiary, associate or jointly controlled entity – one, that the relationship of parent with the subsidiary, associate or jointly controlled entity is intended to be temporary or the subsidiary, associate or joint venture operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent. Similarly, under the Companies Act, 2013, intermediate subsidiary in India is not required to present consolidated financial statements. Ind AS 110 also prescribes certain criteria⁹ where consolidated financial statements are not required. In such cases, the

⁹(a) A parent need not present consolidated financial statements if it meets all the following conditions:

- (i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
 - (ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
 - (iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
 - (iv) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with Ind ASs.
- (b) post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19, *Employee Benefits*, applies.

auditor should satisfy himself that the exclusion made by the management falls within these categories, e.g. in the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary, associate or joint venture is temporary, the auditor should verify that the intention of the parent, to dispose off the subsidiary, investment in associate or interest in jointly controlled entity, in the near future, existed at the time of acquisition of the subsidiary, making investment in associate or jointly controlled entity. The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements. If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the applicable financial reporting framework, the auditor should consider its effect on the auditor's report to be issued.

24. The auditor should also examine whether there is any change in the status of a component (e.g., subsidiary to associate, JV to associates or vice – versa). The auditor, in such cases, should examine whether these changes have been appropriately accounted for in the consolidated financial statements as required by the relevant accounting standards under the applicable financial reporting framework.

25. (a) In preparing consolidated financial statements in accordance with the Companies (Accounting Standards) Rules, 2006, the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, income, expenses and cash flows and then certain calculations like determination of goodwill or capital reserve, minorities interest and adjustments like elimination of intra group transactions, balances and unrealised profits etc. are made in accordance with the requirements of Accounting Standard (AS) 21, "Consolidated Financial Statements". Investments in associates are accounted for using the Equity Method as prescribed in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements". A parent that has an interest in a jointly controlled entity, reports its interest in the consolidated financial statements using proportionate consolidation method in accordance with Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures". Many of the procedures appropriate for the application of equity method and the proportionate consolidation method are similar to the consolidation procedures set out in Accounting Standard (AS) 21, "Consolidated Financial Statements".

(b) For consolidation of subsidiaries in accordance with the Companies (Indian Accounting Standards) Rules, 2015:

- the financial statements of the parent and its subsidiaries are combined as per Ind AS 110, "Consolidated Financial Statements" on a line by line basis by adding together like items of assets, liabilities, income, expenses and cash flows;
- related goodwill/ capital reserve and non-controlling interest is determined as per Ind As 103;

(c) an investment entity need not present consolidated financial statements if it is required, in accordance with paragraph 31 of this Ind AS, to measure all of its subsidiaries at fair value through profit or loss.

III.512 Auditing Pronouncements

- adjustments like elimination of intra group transactions, balances, unrealised profits and deferred tax etc. are made in accordance with the requirements of Ind AS 110.
- Investments in associates and joint ventures are accounted for using the Equity Method as prescribed in Indian Accounting Standard (Ind AS) 28, "Investments in Associates and Joint Ventures". Interests in assets, liabilities, revenues and expenses in a joint operation are accounted for as part of separate financial statements of the entity in accordance with Indian Accounting Standard (Ind AS) 111, "Joint Arrangements".

26. The auditor should verify that the adjustments warranted by the relevant accounting standards under the applicable financial reporting framework have been made wherever required and have been properly approved by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. No adjustments, other than those envisaged in this Guidance Note, can be carried out in the preparation of CFS at the group level.

Special Considerations

Permanent Consolidation Adjustments

27. Permanent consolidation adjustments are those adjustments that are made only on the first occasion or subsequent occasions in which there is a change in the shareholding of a particular entity which is consolidated. Permanent consolidation adjustments are:

- (a) Determination of goodwill or capital reserve as per applicable accounting standards.
- (b) Determination of amount of equity attributable to minority/ non- controlling interests.

28. The auditor should verify that the above calculations have been made appropriately. The auditor should pay particular attention to the determination of pre-acquisition reserves of the components. Date(s) of investment in components assumes importance in this regard. The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minority interests/ non-controlling interests of the subsidiary. The auditor should also verify the changes that might have taken place in these permanent consolidation adjustments on account of subsequent acquisition of shares in the components, disposal of the components in the subsequent years.

29. It may happen that while working out the permanent consolidation adjustments, in the case of one subsidiary, goodwill arises and in the case of another subsidiary a capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet where permitted by the applicable financial reporting framework. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

Current Period Consolidation Adjustments

30. Current period consolidation adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period

consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including:

- (a) intra-group interest paid and received, or management fees, etc.;
- (b) unrealised intra-group profits on assets acquired/ transferred from/ to other subsidiaries;
- (c) intra-group indebtedness;
- (d) adjustments related to harmonising the different accounting policies being followed by the parent and its components;
- (e) adjustments to the financial statements (of the parent and the components being consolidated) for recognized subsequent events or transactions that occur between the balance sheet date and the date of the auditor's report on the consolidated financial statements of the group.

There are two types of subsequent events:

- a. The first type of subsequent events consists of events or transactions that provide additional evidence about conditions that existed at the date of the financial statements, including the estimates inherent in the process of preparing financial statements (i.e. adjusting events).
- b. The second type of subsequent events consists of events that provide evidence about conditions that did not exist at the date of the financial statements but arose subsequent to that date (i.e. non-adjusting events).

Events occurring after balance sheet date which do not require adjustments would not normally require disclosure, although they may be of such significance that they may require a disclosure in the report of approving authority in the case of accounting standards and in the financial statements in case of Ind AS. For such events, the following shall be disclosed:

- a. The nature of the event; and
 - b. An estimate of its financial effect or a statement that such an estimate cannot be made.
- (f) adjustments for the effects of significant transactions or other events that occur between the date of the components balance sheet and not already recognised in its financial statements and the date of the auditor's report on the group's consolidated financial statements when the financial statements of the component to be used for consolidation are not drawn upto the same balance sheet date as that of the parent;
 - (g) In case of a foreign component, adjustments to convert a component's audited financial statements prepared under the component's local GAAP to the GAAP under which the consolidated financial statements are prepared.
 - (h) determination of movement in equity attributable to the minorities interest/non-controlling interest since the date of acquisition of the subsidiary.
 - (i) adjustments of deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from intragroup transactions and undistributed profits of the component in case of consolidated financial statements prepared under Ind AS.

III.514 Auditing Pronouncements

31. The adjustments required for preparation of consolidated financial statements are made in memorandum records kept for the purpose by the parent. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. Apart from reviewing the memorandum records, the auditor should inter alia:

- (a) verify that the intra group transactions and account balances have been eliminated;
- (b) verify that the consolidated financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances;
- (c) verify that adequate disclosures have been made in the consolidated financial statements of application of different accounting policies in case, it was impracticable to harmonize them. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so¹⁰.
- (d) verify the adjustments made to harmonise the different accounting policies including adjustments made by management to convert a component's financial statements prepared under the component's GAAP to the GAAP under which the consolidated financial statements are prepared;
- (e) verify the calculation of minorities/non-controlling interest;
- (f) verify adjustments relating to deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from Intergroup transactions (where the parent's accounts are maintained in Ind AS);
- (g) verify that income and expenses of the subsidiary are included in consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognised in consolidated financial statements at the acquisition date¹¹.

32. The auditor should gain an understanding of the procedures adopted by the management of the enterprise to make the above mentioned adjustments. This helps the auditor in reducing the audit risk to an acceptably low level.

33. One of the important adjustment that may be required in the current period is determination of impairment loss that might exist for goodwill arising on consolidation. Goodwill arising on consolidation is carried at the value determined at the date of acquisition of the component, and the same is to be tested for impairment loss at every balance sheet date.

¹⁰ AS 21/ AS 23/ AS 27 permit application of different accounting policies, if it is impractical to use uniform accounting policies, that fact should be disclosed together with the proportion of the items in the consolidated financial statements to which the different accounting policies have been applied. Ind AS 28 permits that financial statement of an associate can be prepared using different accounting policies if it is impractical to do so however adjustment shall be made to make the accounting policies conform to those of parent when the financial statements are used by parent in applying the equity method.

¹¹ Where the consolidated financial statements are prepared under Indian Accounting Standards.

34. The auditor should examine whether any impairment loss has been determined by the parent. If yes, the auditor should examine the procedure followed for determination of impairment loss. The auditor should satisfy himself that the amount of impairment loss determined is fair. In case the impairment loss in goodwill of a component has been determined in foreign currency, the auditor should verify if any amount of loss in local currency need to be adjusted from currency translation reserve on account of movement in the exchange rate from the date when the goodwill was first accounted for in the consolidated financial statement of parent, to the date of determination of impairment loss.

35. The auditor should also perform audit procedures to understand and verify whether Intragroup losses are indicating an impairment loss that requires recognition in the consolidated financial statements.

36. Apart from verifying that the calculation and disclosures regarding minorities/non-controlling interest have been made appropriately, the auditor also determines, in cases where the minority interests' share of the losses exceed the minority /non-controlling interests' share of the equity, the excess, and any further losses applicable to the minority interest, have been accounted for in accordance with the relevant accounting standards.

37. The financial statements of the components used in the consolidation should be drawn up to the same reporting date as that of the parent. If it is not practicable to draw up the financial statements of one or more components to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months in case of financial statements under AS and three months in case of financial statements under Ind AS. The auditor of the consolidated financial statements should review other components' results between its financial reporting date and that of the parent for significant transactions or other events that have taken place during the period and, therefore, need to be reflected in the consolidated financial statements. Recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position, results of operations or cash flows.

38. The fundamental accounting assumption of "consistency" requires the auditor of the consolidated financial statements to consider whether the length of the reporting periods and any difference in financial year-ends are the same from period to period. If there have been any changes in the respective reporting periods of the components included in the consolidated financial statements that have a material effect on the financial statements, the auditor should ensure that the entity discloses such changes and the manner of treatment in the financial statements.

39. The Ministry of Corporate Affairs has issued a Circular number 39/2014 dated October 14, 2014 stating that Schedule III to the Act read with the applicable Accounting Standards does not envisage that a company while preparing its consolidated financial statements merely repeats the disclosures made by it under separate financial statements being consolidated. In the consolidated financial statements, the company would need to give all disclosures relevant to consolidated financial statements only.

III.516 Auditing Pronouncements

40. Further, Accounting Standard (AS) 21 also lays down certain principles that should be observed while giving the information which is part of the separate financial statements of the Components but that need not be reported in the notes and other explanatory material of the consolidated financial statements. The auditor should:

- (a) examine that the notes required by the applicable standards which are necessary for presenting a true and fair view of the consolidated financial statements have been included in the consolidated financial statements as an integral part thereof; and
- (b) examine that additional statutory information disclosed in the separate financial statements of the subsidiary and/or a parent having bearing on the true and fair view of the consolidated financial statements have been disclosed in the consolidated financial statements.

41. In addition, the information required pursuant to Schedule III to the Companies Act, 2013 ('general instructions for the preparation of consolidated financial statements') should be disclosed. For example, following information is also required to be disclosed in the consolidated financial statements separately for the parent and each of its components (including foreign component) which has been consolidated:

- (i) amount of net assets and net assets as a percentage of consolidated net assets;
- (ii) amount of share in profit or loss and the percentage share in profit or loss as a percentage of consolidated profit or loss;
- (iii) amount in other comprehensive income (OCI) and the percentage of OCI as a percentage of Consolidated OCI.¹²

42. As regards consolidation adjustments (including elimination of intra group transactions), it should be ensured that these are either disclosed as a single line item separately or adjusted in the information (e.g. net assets) disclosed for the parent and its each component.

43. The Ind AS 110 does not give a list of information which is part of the separate financial statement of the components but that need not be reported in the notes and other explanatory material of the consolidated financial statements, however, based on section 129(4) and MCA circular 39/2014 as referred above, it can be construed that, even in consolidated financial statements under Ind AS, only those disclosures should be given which are relevant to consolidated financial statements.

44. Based on the above discussion, in case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary, need not be included in the consolidated financial statements.

- (i) Source from which bonus shares are issued, e.g., capitalisation of profits or Reserves or from Securities Premium Account.

¹² For companies which are covered by Ind AS.

- (ii) Disclosure of all unutilised monies out of the issue indicating the form in which such unutilised funds have been invested.
- (iii) Disclosure required under Micro, Small and Medium Enterprises Development Act, 2006.
- (iv) A statement of investments (whether shown under “financial assets or non-financial assets as stock-in-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.
- (v) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of:
 - (a) raw materials;
 - (b) components and spare parts;
 - (c) capital goods.
- (vi) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters.
- (vii) Value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.
- (viii) The amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related.
- (ix) Earnings in foreign exchange classified under the following heads, namely:-
 - (a) export of goods calculated on F.O.B. basis;
 - (b) royalty, know-how, professional and consultation fees;
 - (c) interest and dividend;
 - (d) other income, indicating the nature thereof.

However, notwithstanding the above, the auditor needs to ensure compliance with disclosure requirements of applicable accounting standards and other applicable laws for consolidated financial statements.

Management Representations

45. Standard on Auditing (SA) 580, “Written Representations” requires the auditor to obtain appropriate representations from management. The auditor of the consolidated financial statements should obtain evidence that the management of the parent acknowledges its responsibility for a true and fair presentation of the consolidated financial statements in accordance with the financial reporting framework applicable to the parent and that parent’s

III.518 Auditing Pronouncements

management has approved the consolidated financial statements. In addition, the auditor of the consolidated financial statements should obtain written representations from parent's management on matters material to the consolidated financial statements. Examples of such representations include:

- (a) Completeness of components included in the consolidated financial statements;
- (b) Identification of reportable segments for segment reporting;
- (c) Identification of related parties and related party transactions for reporting;
- (d) Appropriateness and completeness of permanent and current period consolidation adjustments, including the elimination of intra-group transactions.

Reporting

46. With reference to the auditor's responsibility under paragraph 8, there could be two situations in an audit of consolidated financial statements—when the parent's auditor is also the auditor of all the components to be included in the consolidated financial statements and when the parent's auditor is not the auditor of one or more components and therefore, uses the work of other auditors in the audit. The auditor should, while preparing the report, consider the requirements of Standard on Auditing (SA) 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of Standard on Auditing (SA) 600, "Using the Work of Another Auditor" should also be considered. Reference may also be made to paragraph 16 for using the work of another auditor.

When the Parent's Auditor is also the Auditor of All its components

47. While drafting the audit report, the auditor should report whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed. In case of any departure, the auditor should consider the same while drafting the audit report.

48. Auditor should issue an audit report expressing an opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit. Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statement. Suggested format of the audit report to be issued in such circumstance is given in **Appendix I** to this Guidance Note.

When the Parent's Auditor is not the Auditor of All its Components

49. In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should consider the requirements of SA 600.

50. As prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent's auditor. Total assets, revenues and cash flows not audited by the parent's auditor should be presented before giving effect to permanent and current period consolidation adjustments. Reference in the report of the auditor on the consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries. Suggested format of the audit report to be issued by the auditor of the consolidated financial statements in this circumstance is given in **Appendix I** to this Guidance Note.

When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent

51. The parent may have components located in multiple geographies outside India applying an accounting framework (GAAP) that is different than that of the parent in preparing its financial statements. Foreign components prepare financial statements under different financial reporting frameworks, which may be a well-known framework (such as US GAAP or IFRS) or the local GAAP of the jurisdiction of the component. Local component auditors may be unable to report on financial statements prepared using the parent's GAAP because of their unfamiliarity with such GAAP.

52. When a component's financial statements are prepared under an accounting framework that is different than that of the framework used by the parent in preparing group's consolidated financial statements, the parent's management perform a conversion of the components' audited financial statements from the framework used by the component to the framework under which the consolidated financial statements are prepared. The conversion adjustments are audited by the principal auditor to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation. Suggested format of the audit report to be issued by the auditor of the consolidated financial statements in this circumstance is given in **Appendix I** to this Guidance Note.

53. A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared. The local component auditor can then audit and issue an audit report on the components financial statements prepared in accordance with "group accounting policies".

54. When applying the approach in paragraph 53 above of using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the

GAAP applicable to the parent's financial statements. This ensures that the information prepared under the requirements of the group accounting policies will be directly usable and relevant for the preparation of consolidated financial statements by the parent entity, eliminating the need for auditing by the auditor, the differences between the basis used for the component's financial statements and that of the consolidated financial statements. The Principal auditor can then decide whether or not to rely on the components' audit report and make reference to it in the auditor's report on the consolidated financial statements. See paragraph 50 for additional guidance.

When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent

55. Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("Indian GAAS"). In order to maintain consistency of the auditing framework and to enable the parent auditor to rely and refer to the other auditor's audit report in their audit report on the consolidated financial statements, the components' financial statements should also be audited under a framework that corresponds to Indian GAAS.

Components Not Audited

56. Generally, the financial statements of all components included in consolidated financial statements should be audited or subjected to audit procedures in the context of a multi-location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

57. Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both qualitative and quantitative factors on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report"¹³.

¹³ Refer Announcement on the Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements / Information of Component/s in the Financial Statements audited by the Principal Auditor(s) issued by ICAI in February 2014.

Appendix I

Illustrative Formats of Independent Auditor's Report on Consolidated Financial Statements

Illustration 1: Unmodified Opinion

Note:

The following illustrative format is based on the assumptions that all components have been audited by the Principal Auditor.

The independent auditor of Consolidated Financial Statements:

- Gives an **Unmodified Opinion** on the consolidated financial statements

ILLUSTRATIVE FORMAT OF INDEPENDENT AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS OF A GROUP UNDER THE COMPANIES ACT, 2013 AND THE RULES THEREUNDER

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ABC COMPANY LIMITED

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated Ind AS¹⁴ financial statements of ABC Company Limited (hereinafter referred to as "the Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group") its associates and its jointly controlled entities/joint ventures and joint operations¹⁵, comprising the Consolidated Balance Sheet as at 31st March, 20XX, the Consolidated Statement of Profit and Loss (including other comprehensive income)¹⁶, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity¹⁷, for the year then ended, and a summary of the significant accounting policies and other explanatory information (hereinafter referred to as "the consolidated financial statements").

Management's Responsibility for the Consolidated Financial Statements

The Holding Company's Board of Directors is responsible for the preparation of these consolidated financial statements in terms of the requirements of the Companies Act, 2013 (hereinafter referred to as "the Act") that give a true and fair view of the consolidated financial position, consolidated financial performance (including other comprehensive income)¹⁸,

¹⁴ if applicable.

¹⁵ As the case may be as per the relevant accounting standards.

¹⁶ if applicable.

¹⁷ if applicable.

¹⁸ if applicable.

III.522 Auditing Pronouncements

consolidated cash flows and consolidated statement of changes in equity¹⁹ of the Group including its Associates and Jointly controlled entities/ Joint ventures and Joint operations²⁰ in accordance with the accounting principles generally accepted in India, including the Accounting Standards prescribed under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 / Indian Accounting Standards specified under Section 133 of the Act²¹. The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities /joint ventures and joint operations²² are responsible for maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the Group and its associates and its jointly controlled entities/joint ventures and joint operations²³ and for preventing and detecting frauds and other irregularities; the selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and the design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error, which have been used for the purpose of preparation of the consolidated financial statements by the Directors of the Holding Company, as aforesaid.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. While conducting the audit, we have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Holding Company's preparation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the

¹⁹ if applicable.

²⁰ As the case may be as per the relevant accounting standards.

²¹ Select as applicable.

²² As the case may be as per the relevant accounting standards.

²³ As the case may be as per the relevant accounting standards.

accounting estimates made by the Holding Company's Board of Directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained by us is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid consolidated financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the consolidated state of affairs (financial position) of the Group, its associates and jointly controlled entities /joint ventures and joint operations²⁴ as at 31st March, 20XX, and their consolidated profit/loss (financial performance including other comprehensive income)²⁵, their consolidated cash flows and consolidated statement of changes in equity²⁶ for the year ended on that date.

Report on Other Legal and Regulatory Requirements

As required by Section 143(3) of the Act, we report, to the extent applicable, that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit of the aforesaid consolidated financial statements.
- (b) In our opinion, proper books of account as required by law relating to preparation of the aforesaid consolidated financial statements have been kept so far as it appears from our examination of those books and the reports of the other auditors.
- (c) The Consolidated Balance Sheet, the Consolidated Statement of Profit and Loss, the Consolidated Cash Flow Statement, and Consolidated Statement of Changes in Equity²⁷ dealt with by this Report are in agreement with the relevant books of account maintained for the purpose of preparation of the consolidated financial statements.
- (d) In our opinion, the aforesaid consolidated financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 /Indian Accounting Standards specified under Section 133 of the Act²⁸.
- (e) On the basis of the written representations received from the directors of the Holding Company as on 31st March, 20XX taken on record by the Board of Directors of the Holding Company and the reports of the statutory auditors of its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations incorporated in

²⁴ As the case may be as per the relevant accounting standards.

²⁵ if applicable.

²⁶ if applicable.

²⁷ if applicable.

²⁸ Select as applicable.

III.524 Auditing Pronouncements

India, none of the directors of the Group companies, its associate companies and jointly controlled entities/ joint venture and joint operations²⁹ incorporated in India is disqualified as on 31st March 20XX from being appointed as a director in terms of Section 164 (2) of the Act.

- (f) With respect to the adequacy of the internal financial controls over financial reporting of the Holding Company, its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations³⁰ incorporated in India and the operating effectiveness of such controls, refer to our separate Report in “Annexure A”.
- (g) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditor's) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
- i. The consolidated financial statements disclose the impact of pending litigations on the consolidated financial position of the Group, its associates and jointly controlled entities /joint ventures and joint operations³¹ - Refer Note XX to the consolidated financial statements.

Or

There were no pending litigations as at 31st March, 20XX which would impact the consolidated financial position of the Group, its associates and jointly controlled entities /joint ventures and joint operations³².

- ii. Provision has been made in the consolidated financial statements, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts - Refer (a) Note XX to the consolidated financial statements in respect of such items as it relates to the Group, its associates and jointly controlled entities /joint ventures and joint operations³³ and (b) the Group's share of net profit/loss in respect of its associates.

Or

The Group, its associates and jointly controlled entities/joint ventures and joint operations³⁴ did not have any material foreseeable losses on long-term contracts including derivative contracts during the year ended 31st March, 20XX .

- iii. There are no amounts which are required to be transferred to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations³⁵ incorporated in India during the year ended 31st March 20XX.

²⁹ As the case may be as per the relevant accounting standards.

³⁰ As the case may be as per the relevant accounting standards.

³¹ As the case may be as per the relevant accounting standards.

³² As the case may be as per the relevant accounting standards.

³³ As the case may be as per the relevant accounting standards.

³⁴ As the case may be as per the relevant accounting standards.

³⁵ As the case may be as per the relevant accounting standards.

Or

There has been no delay in transferring amounts to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations³⁶ incorporated in India during the year ended 31st March 20XX.

Or

The following are the instances of delay in transferring amounts, to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations³⁷ incorporated in India during the year ended 31st March 20XX: [describe the delays, covering date of payment, amount involved and number of days' delay.]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)

(Designation³⁸)
(Membership No. XXXXX)

Place of Signature:

Date:

³⁶ As the case may be as per the relevant accounting standards.

³⁷ As the case may be as per the relevant accounting standards.

³⁸ Partner or Proprietor as the case may be.

Illustration 2: Unmodified Opinion

Note:

The following illustrative format is based on the assumptions that the Group has:

- Certain components which have been audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the consolidated financial statements of the Group. The auditors of such components which are Indian companies, and they did not have any matter to report under section 143(3)(f) of the Companies Act, 2013.
- Certain components which are unaudited and such component/s is/ are not material to the consolidated financial statements of the Group.

The independent auditor of Consolidated Financial Statements:

- Gives an **Unmodified Opinion** on the consolidated financial statements.
- Discloses the aforementioned facts about the Components in the "Other Matters" Paragraph in accordance with the Announcement issued by the Auditing and Assurance Standards Board under the authority of the Council of ICAI in February 2014.

ILLUSTRATIVE FORMAT OF INDEPENDENT AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS OF A GROUP UNDER THE COMPANIES ACT, 2013 AND THE RULES THEREUNDER

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ABC COMPANY LIMITED

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated Ind AS³⁹ financial statements of ABC Company Limited (hereinafter referred to as "the Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group") its associates and its jointly controlled entities/joint ventures and joint operations⁴⁰, comprising the Consolidated Balance Sheet as at 31st March, 20XX, the Consolidated Statement of Profit and Loss (including other comprehensive income)⁴¹, the Consolidated Cash Flow Statement, Consolidated Statement of Changes in Equity⁴², for the year then ended, and a summary of the significant accounting policies and other explanatory information (hereinafter referred to as "the consolidated financial statements").

³⁹ if applicable.

⁴⁰ As the case may be as per the relevant accounting standards.

⁴¹ if applicable.

⁴² if applicable.

Management's Responsibility for the Consolidated Financial Statements

The Holding Company's Board of Directors is responsible for the preparation of these consolidated financial statements in terms of the requirements of the Companies Act, 2013 (hereinafter referred to as "the Act") that give a true and fair view of the consolidated financial position, consolidated financial performance (including other comprehensive income)⁴³, consolidated cash flows and consolidated statement of changes in equity⁴⁴ of the Group including its Associates and Jointly controlled entities /Joint ventures and Joint operations⁴⁵ in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 / Indian Accounting Standards prescribed under Section 133 of the Act⁴⁶. The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities /joint ventures and joint operations⁴⁷ are responsible for maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the Group and its associates and its jointly controlled entities/joint ventures and joint operations⁴⁸ and for preventing and detecting frauds and other irregularities; the selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and the design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error, which have been used for the purpose of preparation of the consolidated financial statements by the Directors of the Holding Company, as aforesaid.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. While conducting the audit, we have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the

⁴³ if applicable.

⁴⁴ if applicable.

⁴⁵ As the case may be as per the relevant accounting standards.

⁴⁶ Select as applicable.

⁴⁷ As the case may be as per the relevant accounting standards.

⁴⁸ As the case may be as per the relevant accounting standards.

consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Holding Company's preparation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the Holding Company's Board of Directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained by us and the audit evidence obtained by the other auditors in terms of their reports referred to in sub-paragraph (a) of the Other Matters paragraph below, is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

Opinion

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of reports of other auditors on separate financial statements and on the other financial information of the subsidiaries, associates and jointly controlled entities/joint ventures and joint operations⁴⁹, the aforesaid consolidated financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the consolidated state of affairs (financial position) of the Group, its associates and jointly controlled entities /joint ventures and joint operations⁵⁰ as at 31st March, 20XX, and their consolidated profit/loss (financial performance including other comprehensive income)⁵¹, their consolidated cash flows and consolidated statement of changes in equity⁵² for the year ended on that date.

Other Matters

(a) We did not audit the financial statements/ financial information of _____ subsidiaries, and _____ jointly controlled entities /joint operations⁵³, whose financial statements/ financial information reflect total assets of Rs. _____ and net assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash outflows/(inflows)⁵⁴ amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of _____ associates and joint ventures, whose financial statements / financial information have not been audited by us. These financial statements / financial information have been audited by other auditors whose reports have been furnished to us by the Management and our opinion on the consolidated financial

⁴⁹ As the case may be as per the relevant accounting standards.

⁵⁰ As the case may be as per the relevant accounting standards.

⁵¹ if applicable.

⁵² if applicable.

⁵³ As the case may be as per the relevant accounting standards.

⁵⁴ Please delete what is not applicable in the given case.

statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities /joint ventures and joint operations⁵⁵ and associates, and our report in terms of sub-section (3) of Section 143 of the Act, insofar as it relates to the aforesaid subsidiaries, jointly controlled entities /joint ventures and joint operations⁵⁶ and associates, is based solely on the reports of the other auditors.

Certain of these subsidiaries/associates/ joint ventures and joint operations are located outside India whose financial statements and other financial information have been prepared in accordance with accounting principles generally accepted in their respective countries and which have been audited by other auditors under generally accepted auditing standards applicable in their respective countries. The Company's management has converted the financial statements of such subsidiaries/associates/ joint ventures and joint operations located outside India from accounting principles generally accepted in their respective countries to accounting principles generally accepted in India. We have audited these conversion adjustments made by the Company's management. Our opinion in so far as it relates to the balances and affairs of such subsidiaries/associates/ joint ventures and joint operations located outside India is based on the report of other auditors and the conversion adjustments prepared by the management of the Company and audited by us.

- (b) We did not audit the financial statements / financial information of _____ subsidiaries and _____ jointly controlled entities/ joint operations⁵⁷, whose financial statements/ financial information reflect total assets of Rs. _____ and net assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash outflows/(inflows)⁵⁸ amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of _____ associates and joint ventures, whose financial statements / financial information have not been audited by us. These financial statements / financial information are unaudited and have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities /joint ventures and joint operations⁵⁹ and associates, and our report in terms of sub-section (3) of Section 143 of the Act in so far as it relates to the aforesaid subsidiaries, jointly controlled entities /joint ventures and joint operations⁶⁰ and associates, is based solely on such unaudited financial statements / financial information. In our opinion and according to the information and explanations given to us by the Management, these financial statements/financial information are not material to the Group.

⁵⁵ As the case may be as per the relevant accounting standards.

⁵⁶ As the case may be as per the relevant accounting standards.

⁵⁷ As the case may be as per the relevant accounting standards.

⁵⁸ Please delete what is not applicable in the given case.

⁵⁹ As the case may be as per the relevant accounting standards.

⁶⁰ As the case may be as per the relevant accounting standards.

Our opinion above on the consolidated financial statements, and our report on Other Legal and Regulatory Requirements below, is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors and the financial statements/ financial information certified by the Management.

Report on Other Legal and Regulatory Requirements

As required by Section 143(3) of the Act, based on our audit and on the consideration of report of the other auditors on separate financial statements and the other financial information of subsidiaries, associates and jointly controlled entities/joint ventures and joint operations⁶¹, as noted in the 'other matter' paragraph, we report, to the extent applicable, that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit of the aforesaid consolidated financial statements.
- (b) In our opinion, proper books of account as required by law relating to preparation of the aforesaid consolidated financial statements have been kept so far as it appears from our examination of those books and the reports of the other auditors.
- (c) The Consolidated Balance Sheet, the Consolidated Statement of Profit and Loss, the Consolidated Cash Flow Statement and Consolidated Statement of Changes in Equity⁶² dealt with by this Report are in agreement with the relevant books of account maintained for the purpose of preparation of the consolidated financial statements.
- (d) In our opinion, the aforesaid consolidated financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 /Indian Accounting Standards specified under Section 133 of the Act⁶³.
- (e) On the basis of the written representations received from the directors of the Holding Company as on 31st March, 20XX taken on record by the Board of Directors of the Holding Company and the reports of the statutory auditors of its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations⁶⁴ incorporated in India, none of the directors of the Group companies, its associate companies and jointly controlled companies/joint venture incorporated in India is disqualified as on 31st March 20XX from being appointed as a director in terms of Section 164(2) of the Act.
- (f) With respect to the adequacy of the internal financial controls over financial reporting of the Holding Company, its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations⁶⁵ incorporated in India and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

⁶¹ As the case may be as per the relevant accounting standards.

⁶² if applicable.

⁶³ Select as applicable.

⁶⁴ As the case may be as per the relevant accounting standards.

⁶⁵ As the case may be as per the relevant accounting standards.

(g) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditor's) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the report of the other auditors on separate financial statements as also the other financial information of the subsidiaries, associates and jointly controlled entities/joint ventures and joint operations⁶⁶, as noted in the 'Other matter' paragraph:

i. The consolidated financial statements disclose the impact of pending litigations on the consolidated financial position of the Group, its associates and jointly controlled entities /joint ventures and joint operations⁶⁷. Refer Note XX to the consolidated financial statements.

Or

There were no pending litigations as at 31st March 20XX which would impact the consolidated financial position of the Group, its associates and jointly controlled entities /joint ventures and joint operations⁶⁸.

ii. Provision has been made in the consolidated financial statements, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts - Refer (a) Note XX to the consolidated financial statements in respect of such items as it relates to the Group, its associates and jointly controlled entities /joint ventures and joint operations⁶⁹ and (b) the Group's share of net profit/loss in respect of its associates.

Or

The Group, its associates and jointly controlled entities /joint ventures and joint operations⁷⁰ did not have any material foreseeable losses on long-term contracts including derivative contracts during the year ended 31st March 20XX.

iii. There are no amounts which are required to be transferred to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations⁷¹ incorporated in India during the year ended 31st March 20XX.

Or

There has been no delay in transferring amounts to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations⁷²

⁶⁶ As the case may be as per the relevant accounting standards.

⁶⁷ As the case may be as per the relevant accounting standards.

⁶⁸ As the case may be as per the relevant accounting standards.

⁶⁹ As the case may be as per the relevant accounting standards.

⁷⁰ As the case may be as per the relevant accounting standards.

⁷¹ As the case may be as per the relevant accounting standards.

⁷² As the case may be as per the relevant accounting standards.

III.532 Auditing Pronouncements

incorporated in India during the year ended 31st March 20XX.

Or

The following are the instances of delay in transferring amounts, to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled companies incorporated in India during the year ended 31st March 20XX: [describe the delays, covering date of payment, amount involved and number of days' delay.]

For XYZ & Co.
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation⁷³)
(Membership No. XXXXX)

Place of Signature:

Date:

⁷³ Partner or Proprietor as the case may be.

Illustration 3: Modified Opinion

Note:

The following illustrative format is based on the assumptions that the Group has:

- Certain components which have been audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the consolidated financial statements of the Group. The auditors of such components which are Indian companies, and they have issued a modified opinion and also reported under section 143(3)(f) and 143(3)(h) of the Companies Act, 2013.
- Certain components which are unaudited and such component/s is/ are not material to the consolidated financial statements of the Group.

The independent auditor of Consolidated Financial Statements:

- Gives a **Modified Opinion** on the consolidated financial statements.
- Discloses the aforementioned facts about the Components in the "Other Matters" Paragraph in accordance with the Announcement issued by the Auditing and Assurance Standards Board under the authority of the Council of ICAI in February 2014.

ILLUSTRATIVE FORMAT OF INDEPENDENT AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS OF A GROUP UNDER THE COMPANIES ACT, 2013 AND THE RULES THEREUNDER

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ABC COMPANY LIMITED

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated Ind AS⁷⁴ financial statements of ABC Company Limited (hereinafter referred to as "the Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group") its associates and its jointly controlled entities/joint ventures and joint operations⁷⁵, comprising the Consolidated Balance Sheet as at 31st March, 20XX, the Consolidated Statement of Profit and Loss (including other comprehensive income)⁷⁶, the Consolidated Cash Flow Statement, Consolidated Statement of Changes in Equity⁷⁷, for the year then ended, and a summary of the significant accounting policies and other explanatory information (hereinafter referred to as "the consolidated financial statements").

Management's Responsibility for the Consolidated Financial Statements

The Holding Company's Board of Directors is responsible for the preparation of these

⁷⁴ if applicable.

⁷⁵ As the case may be as per the relevant accounting standards.

⁷⁶ if applicable.

⁷⁷ if applicable.

consolidated financial statements in terms of the requirements of the Companies Act, 2013 (hereinafter referred to as "the Act") that give a true and fair view of the consolidated financial position, consolidated financial performance (including other comprehensive income)⁷⁸, consolidated cash flows and consolidated statement of changes in equity⁷⁹ of the Group including its Associates and Jointly controlled entities /Joint ventures and Joint operations⁸⁰ in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 / Indian Accounting Standards prescribed under Section 133 of the Act⁸¹. The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities /joint ventures and joint operations⁸² are responsible for maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the Group and its associates and its jointly controlled entities/joint ventures and joint operations⁸³ and for preventing and detecting frauds and other irregularities; the selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and the design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error, which have been used for the purpose of preparation of the consolidated financial statements by the Directors of the Holding Company, as aforesaid.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. While conducting the audit, we have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Holding Company's

⁷⁸ if applicable.

⁷⁹ if applicable.

⁸⁰ As the case may be as per the relevant accounting standards.

⁸¹ Select as applicable.

⁸² As the case may be as per the relevant accounting standards.

⁸³ As the case may be as per the relevant accounting standards.

preparation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the Holding Company's Board of Directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained by us and the audit evidence obtained by the other auditors in terms of their reports referred to in sub-paragraph (a) of the Other Matters paragraph below, is sufficient and appropriate to provide a basis for our qualified audit opinion on the consolidated financial statements.

Basis for Qualified Opinion

We draw your attention to the following qualification to the audit opinion of the financial statements of [Name of the subsidiary company], a subsidiary of the Holding Company issued by an independent firm of Chartered Accountants vide its Report dated [date] reproduced by us as under:

“[State the Basis for Qualified Opinion as included by the component auditor in his report]”

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of reports of other auditors on separate financial statements and on the other financial information of the subsidiaries, associates and jointly controlled entities/joint ventures and joint operations⁸⁴, the aforesaid consolidated financial statements give the information required by the Act in the manner so required and except for the effects of the matter referred to in the Basis for Qualified Opinion paragraph above, give a true and fair view in conformity with the accounting principles generally accepted in India, of the consolidated state of affairs (financial position) of the Group, its associates and jointly controlled entities /joint ventures and joint operations⁸⁵ as at 31st March, 20XX, and their consolidated profit/loss (financial performance including other comprehensive income)⁸⁶, their consolidated cash flows and consolidated statement of changes in equity⁸⁷ for the year ended on that date.

Other Matters

- (a) We did not audit the financial statements / financial information of _____ subsidiaries, and _____ jointly controlled entities /joint operations⁸⁸, whose financial statements/ financial information reflect total assets of Rs. _____ and net assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash outflows/(inflows)⁸⁹ amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____

⁸⁴ As the case may be as per the relevant accounting standards.

⁸⁵ As the case may be as per the relevant accounting standards.

⁸⁶ if applicable.

⁸⁷ if applicable.

⁸⁸ As the case may be as per the relevant accounting standards.

⁸⁹ Please delete what is not applicable in the given case.

____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of ____ associates and joint ventures, whose financial statements / financial information have not been audited by us. These financial statements / financial information have been audited by other auditors whose reports have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities / joint ventures and joint operations⁹⁰ and associates, and our report in terms of sub-section (3) of Section 143 of the Act, insofar as it relates to the aforesaid subsidiaries, jointly controlled entities / joint ventures and joint operations⁹¹ and associates, is based solely on the reports of the other auditors.

Certain of these subsidiaries/associates/ joint ventures and joint operations are located outside India whose financial statements and other financial information have been prepared in accordance with accounting principles generally accepted in their respective countries and which have been audited by other auditors under generally accepted auditing standards applicable in their respective countries. The Company's management has converted the financial statements of such subsidiaries/associates/ joint ventures and joint operations located outside India from accounting principles generally accepted in their respective countries to accounting principles generally accepted in India. We have audited these conversion adjustments made by the Company's management. Our opinion in so far as it relates to the balances and affairs of such subsidiaries/associates/ joint ventures and joint operations located outside India is based on the report of other auditors and the conversion adjustments prepared by the management of the Company and audited by us.

- (b) We did not audit the financial statements / financial information of subsidiaries and jointly controlled entities/ joint operations⁹², whose financial statements/financial information reflect total assets of Rs. ____ and net assets of Rs. ____ as at 31st March, 20XX, total revenues of Rs. ____ and net cash outflows/(inflows)⁹³ amounting to Rs. ____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. ____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of ____ associates and joint ventures, whose financial statements / financial information have not been audited by us. These financial statements / financial information are unaudited and have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities / joint ventures and joint operations⁹⁴ and associates, and our report in terms of sub-section (3) of Section 143 of the Act in so far as it relates to the aforesaid subsidiaries, jointly controlled

⁹⁰ As the case may be as per the relevant accounting standards.

⁹¹ As the case may be as per the relevant accounting standards.

⁹² As the case may be as per the relevant accounting standards.

⁹³ Please delete what is not applicable in the given case.

⁹⁴ As the case may be as per the relevant accounting standards.

entities /joint ventures and joint operations⁹⁵ and associates, is based solely on such unaudited financial statements/ financial information. In our opinion and according to the information and explanations given to us by the Management, these financial statements/ financial information are not material to the Group.

Our opinion above on the consolidated financial statements, and our report on Other Legal and Regulatory Requirements below, is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors and the financial statements/ financial information certified by the Management.

Report on Other Legal and Regulatory Requirements

As required by Section 143(3) of the Act, based on our audit and on the consideration of report of the other auditors on separate financial statements and the other financial information of subsidiaries, associates and jointly controlled entities/joint ventures and joint operations⁹⁶, as noted in the 'other matter' paragraph, we report, to the extent applicable, that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit of the aforesaid consolidated financial statements.
- (b) In our opinion, proper books of account as required by law relating to preparation of the aforesaid consolidated financial statements have been kept so far as it appears from our examination of those books and the reports of the other auditors, except as stated in the auditor's report dated [date] on the financial statements of [Name of the component], a subsidiary of the Holding Company, issued by an independent firm of Chartered Accountants which is reproduced as below:
"[State the remark as included by the component auditor in his report]."
- (c) The Consolidated Balance Sheet, the Consolidated Statement of Profit and Loss, the Consolidated Cash Flow Statement and Consolidated Statement of Changes in Equity⁹⁷ dealt with by this Report are in agreement with the relevant books of account maintained for the purpose of preparation of the consolidated financial statements.
- (d) In our opinion, the aforesaid consolidated financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 /Indian Accounting Standards specified under Section 133 of the Act⁹⁸.
- (e) The audit report on the financial statements of [Name of the subsidiary], a subsidiary of the Holding Company, issued by an independent firm of Chartered Accountants *vide* its audit report dated [date] contains the following remark, which is reproduced by us as below:

⁹⁵ As the case may be as per the relevant accounting standards.

⁹⁶ As the case may be as per the relevant accounting standards.

⁹⁷ if applicable.

⁹⁸ Select as applicable.

“The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Group.”

(f) On the basis of the written representations received from the directors of the Holding Company as on 31st March, 20XX taken on record by the Board of Directors of the Holding Company and the reports of the statutory auditors of its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations⁹⁹ incorporated in India, none of the directors of the Group companies, its associate companies and jointly controlled companies/joint venture incorporated in India is disqualified as on 31st March 20XX from being appointed as a director in terms of Section 164(2) of the Act.

(g) The audit report on the financial statements of [Name of the subsidiary], a subsidiary of the Holding Company, issued by an independent firm of Chartered Accountants *vide* its audit report dated [date] contains the following remark, which is reproduced by us as below:

“The qualification relating to maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.”

(h) With respect to the adequacy of the internal financial controls over financial reporting of the Holding Company, its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations¹⁰⁰ incorporated in India and the operating effectiveness of such controls, refer to our separate Report in “Annexure A”.

(i) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditor's) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the report of the other auditors on separate financial statements as also the other financial information of the subsidiaries, associates and jointly controlled entities/joint ventures and joint operations¹⁰¹, as noted in the ‘Other matter’ paragraph:

i. The consolidated financial statements disclose the impact of pending litigations on the consolidated financial position of the Group, its associates and jointly controlled entities /joint ventures and joint operations¹⁰². Refer Note XX to the consolidated financial statements.

Or

There were no pending litigations as at 31st March 20XX which would impact the consolidated financial position of the Group, its associates and jointly controlled entities/joint ventures and joint operations¹⁰³

ii. Provision has been made in the consolidated financial statements, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on

⁹⁹ As the case may be as per the relevant accounting standards.

¹⁰⁰ As the case may be as per the relevant accounting standards.

¹⁰¹ As the case may be as per the relevant accounting standards.

¹⁰² As the case may be as per the relevant accounting standards.

¹⁰³ As the case may be as per the relevant accounting standards.

long-term contracts including derivative contracts - Refer (a) Note XX to the consolidated financial statements in respect of such items as it relates to the Group, its associates and jointly controlled entities /joint ventures and joint operations¹⁰⁴ and (b) the Group's share of net profit/loss in respect of its associates.

Or

The Group, its associates and jointly controlled entities /joint ventures and joint operations¹⁰⁵ did not have any material foreseeable losses on long-term contracts including derivative contracts during the year ended 31st March 20XX.

- iii. There are no amounts which are required to be transferred to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations¹⁰⁶ incorporated in India during the year ended 31st March 20XX.

Or

There has been no delay in transferring amounts to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled entities/ joint ventures and joint operations¹⁰⁷ incorporated in India during the year ended 31st March 20XX.

Or

The following are the instances of delay in transferring amounts, to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled companies incorporated in India during the year ended 31st March 20XX: [describe the delays, covering date of payment, amount involved and number of days' delay.]

For XYZ & Co.
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁰⁸)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁰⁴ As the case may be as per the relevant accounting standards.

¹⁰⁵ As the case may be as per the relevant accounting standards.

¹⁰⁶ As the case may be as per the relevant accounting standards.

¹⁰⁷ As the case may be as per the relevant accounting standards.

¹⁰⁸ Partner or Proprietor as the case may be.

Appendix II

Definitions of Terms used in the Guidance Note

(This Appendix form part of the Guidance Note. The purpose of this Appendix is to define the terms which have been used in this Guidance Note)

Terms defined under Accounting Standards

1. **Associate:** An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.
2. **Consolidated financial statements:** Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.
3. **Control:**
 - a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or
 - b. control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.
4. **Group:** A group comprises a parent and its subsidiaries.
5. **Joint control:** Joint control is the contractually agreed sharing of control over an economic activity.
6. **Joint venture:** A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.
7. **Minority interest:** Minority interest is that part of the net results of operations and of net assets of a subsidiary attributable to interests which are not owned, directly or indirectly, through subsidiary(ies), by the parent.
8. **Parent:** A parent is an enterprise that has one or more subsidiaries.
9. **Significant influence:** Significant influence is the power to participate in the financial and/ or operating policy decisions of the investee but not control over those policies.
10. **Subsidiary:** A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

Terms defined under Ind AS

1. **Associate:** An associate is an entity over which the investor has significant influence.
2. **Control of an investee:** An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
3. **Consolidated financial statements:** The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

4. **Group:** A parent and its subsidiaries.
5. **Joint Control:** Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
6. **Joint Venture:** A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
7. **Non-controlling Interest:** Equity in a subsidiary not attributable, directly or indirectly, to a parent.
8. **Parent:** An entity that controls one or more entities.
9. **Power:** Existing rights that give the current ability to direct the relevant activities.
10. **Relevant Activities:** Relevant activities are activities of the investee that significantly affect the investee's returns.
11. **Significant influence:** Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
12. **Subsidiary:** An entity that is controlled by another entity.
13. **Separate Financial Statements:** separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109, 'Financial Instruments'.

Terms defined under SA 600, "Using the Work of Another Auditor"

1. **Component:** It is a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by principal auditor.

Guidance Note on Audit of Internal Financial Controls Over Financial Reporting

SECTION I: BACKGROUND

Introduction

1. Internal control helps entities achieve important objectives and sustain and improve performance.

Paragraph 4(c) of the Standard on Auditing (SA) 315 “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” defines the term ‘internal control’ as “the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.”

SA 315 requires the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity’s internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement and help the auditor to reduce the risks of material misstatement to an acceptably low level.

2. Section 217(2AA) of the Companies Act, 1956 required the Directors of a company to specifically state in the Directors’ responsibility statement that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the (1956) Act, for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

The Act, 2013 has significantly expanded the scope of internal controls to be considered by the management of companies to cover all aspects of the operations of the company. Clause (e) of Sub-section 5 of Section 134 to the Act requires the directors responsibility statement to state that the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

3. The concept of internal financial controls is not new in India for listed companies. Clause 49 of the Equity Listing Agreement requires certification by the CEO / CFO stating that they accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the audit committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify those deficiencies.

Auditors' Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India

4. Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Reporting on internal financial controls over financial reporting under the 2013 Act vis-à-vis reporting on internal controls under the Companies (Auditor's Report) Order, 2015 (CARO)

5. The scope for reporting on internal financial controls over financial reporting is significantly larger and wider than the reporting on internal controls under CARO. Under CARO the reporting on internal controls is limited to the "adequacy" of controls over purchase of inventory and fixed assets and sale of goods and services. As such, CARO does not require reporting on all controls relating to financial reporting and also does not require reporting on the "adequacy and operating effectiveness" of such controls.

Reporting on internal financial controls over financial reporting – global

scenario : In June 2003, the Securities and Exchange Commission (SEC) of the United States of America adopted Rules for the implementation of Sarbanes – Oxley Act, 2002 (SOX) that required certification of the Internal Controls over Financial Reporting (ICFR) by the management and by the auditors.

The Public Company Accounting Oversight Board (PCAOB) has issued its Auditing Standard (AS) 5 on "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of

III.544 Auditing Pronouncements

Financial Statements". This Standard establishes requirements and provides direction that applies when an auditor is engaged to also perform an audit of the internal controls over financial reporting in addition to the audit of the financial statements.

6. In June 2006, the Financial Instruments and Exchange Act (J-SOX) was passed by the Diet, the National Legislature of Japan. The requirements of this legislation are similar to the requirements of internal controls over financial reporting under SOX.

Reporting by the Auditors

8. Where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

Combined audit of internal financial controls over financial reporting and financial statements

9. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously. In a combined audit of internal controls over financial reporting and financial statements, the auditor expresses opinion on the following aspects:

- a. Opinion on internal control over financial reporting, which requires:
 - Evaluating and opining on management's assessment of the effectiveness of internal financial controls (In Japan based on the requirements of the Financial Instruments and Exchange Act).
 - Evaluating and opining on the effectiveness of internal controls over financial reporting (In USA based on the requirements of Section 404 of the Sarbanes – Oxley Act).
- b. Opinion on the financial statements.

10. While the objectives of the audit of internal controls over financial reporting and audit of financial statements are not identical, the auditor plans and performs the work to achieve the objectives of both the audits in an integrated manner. Therefore, in a combined audit of internal financial controls over financial reporting and financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously.

11. In such an audit, the auditor plans and conducts the audit:

- To obtain sufficient evidence to support the auditor's opinion on the internal financial controls as of the year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of the financial statements.

12. Obtaining sufficient evidence to support control risk assessments of "Low" for purposes of the financial statements audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

13. Unlike the requirements in Japan referred in paragraph 9 above, in India, auditors are not required to report on the management's assertion of effectiveness on internal financial controls. Reporting under the Act will be an independent assessment and assertion by the auditor on the adequacy and effectiveness of the entity's system of internal financial controls.

SECTION II :REPORTING ON INTERNAL FINANCIAL CONTROLS UNDER THE COMPANIES ACT, 2013

Criteria to be considered by companies for developing, establishing and reporting on internal financial controls over financial reporting

14. Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

15. To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

16. Similarly, a benchmark system of internal control, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy and compliance of the system of internal control.

17. In the Indian context, for example, the Appendix 1 "Internal Control Components" of SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"¹, issued by ICAI, provides the necessary criteria for Internal financial controls over financial reporting for companies.

18. Internal control is a process/set of processes designed to facilitate and support the achievement of business objectives. Any system of internal control is based on a consideration of significant risks in operations, compliance and financial reporting. Objectives such as improving business effectiveness are included, as are compliance and reporting objectives.

¹ Refer Section III of this Guidance Note.

III.546 Auditing Pronouncements

19. The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

20. Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

21. **An internal control system:**

- Facilitates the effectiveness and efficiency of operations.
- Helps ensure the reliability of internal and external financial reporting.
- Assists compliance with laws and regulations.
- Helps safeguarding the assets of the entity.

22. In general, a system of internal control to be considered adequate should include the following five components:

- Control environment
- Risk assessment
- Control activities
- Information system and communication
- Monitoring.

The components of internal control are discussed in more detail in Section III of this Guidance Note.

23. Internal financial controls system needs to be dynamic to address the changes in entity's operating environment, including:

- Business developments, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Legal and regulatory developments such as changes in industry regulations and new regulatory reporting requirements.
- Changes in the financial reporting framework, such as changes in accounting standards.

24. Internal financial controls should not be confused with Enterprise Risk Management (ERM). Internal control is an integral part of enterprise risk management. The following are some of the key differences between internal controls over financial reporting and ERM:

- ERM is applied in strategy setting while internal financial controls operate more at the process level.
- ERM is applied across the enterprise, at every level and unit, and includes taking an entity level portfolio view of risk while internal financial controls are applied for the processes which contribute to financial reporting.

25. It may be noted that Clause (n) of Sub-section 3 of Section 134 of the Act requires the board report to include a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the board may threaten the existence of the company. The existence of an appropriate system of internal financial control does not by itself provide an assurance to the board of directors that the company has developed and implemented an appropriate risk management policy.

Objective in an audit of internal financial controls over financial reporting and interpretation of the term 'internal financial controls' for auditor's reporting under Section 143(3)(i)

26. Meaning of internal financial controls under the Act

Clause (e) of Sub-section 5 of Section 134 which explains the meaning of internal financial controls specifically states that the meaning is for the purpose of that clause. The explanation provided in clause (e) of Sub-section 5 of Section 134, inter alia, states that the internal financial controls system includes policies and procedures for ensuring efficiency and effectiveness of business and ensuring accuracy of accounting records.

27. Meaning of internal control

Standard on Auditing 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment" defines Internal Control as follows:

"The process **designed, implemented and maintained** by those charged with governance, management and other personnel **to provide reasonable assurance** about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control." (Emphasis added)

28. Objectives of an auditor in an audit of internal financial controls over financial reporting

The auditor's objective in an audit of internal financial controls over financial reporting is to express an opinion on the effectiveness of the company's internal financial controls over financial reporting. It is carried out along with an audit of the financial statements. Because a company's internal controls cannot be considered effective if one or more material weakness exists, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the balance sheet date. A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.

29. Paragraph A1 of Standard on Auditing (SA) 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states "The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. **The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.**" (Emphasis added)

30. Paragraph A1 of the SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing further states that “in some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.” Thus, it may be noted that even if the auditor performs his or her audit in accordance with the Standards on Auditing, the auditor will not be able to express an opinion on the adequacy or effectiveness with which management has conducted the affairs (business) of the entity.

31. Reporting under Section 143(3)(i)

The reporting by the auditor is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

As discussed above, establishing an appropriate criteria and system of internal financial controls over financial reporting to, inter alia, ensure efficiency and effectiveness of business and accuracy of accounting records is the responsibility of the company’s management.

32. Globally also, auditor’s reporting on internal controls is together with the reporting on the financial statements and such internal controls reported upon relate only to internal controls over financial reporting. For example, in USA, Section 404 of the Sarbanes Oxley Act of 2002, prescribes that the registered public accounting firm (auditor) of the specified class of issuers (companies) shall, in addition to the attestation of the financial statements, attest the internal controls over financial reporting.

33. It may be noted that in India too, the Act specifies the auditor’s reporting on internal financial controls only in the context of the audit of financial statements.

Further, **Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the “financial statements” only.**

34. Consistent with the above requirements of the Act and the Rules thereunder as well as the practice prevalent globally, **the term ‘internal financial controls’ wherever used in this Guidance Note in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the Act, per se implies and relates to “internal financial controls over financial reporting”.**

For this purpose, “internal financial controls over financial reporting” shall mean,

“A process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel, to provide reasonable assurance regarding

the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.”²

The process may also be designed by, or under the supervision of a committee or group of the aforesaid persons.

35. Considering the above, the auditor should obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only.

Applicability of standards on auditing for the audit of internal financial controls over financial reporting

36. Paragraph A1 of SA 200, *inter alia*, states “In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.”

Accordingly, the Standards on Auditing do not fully address the auditing requirements for reporting on the system of internal financial controls over financial reporting. However, relevant portions of the Standards on Auditing need to be considered by the auditor when performing an audit of internal financial controls over financial reporting. For example, the auditor should consider the requirements of SA 230, “Audit Documentation” when documenting the work performed on internal financial controls; the auditor should consider and apply the requirements of SA 315 when understating internal controls, etc.

37. This guidance aims to provide the supplementary procedures that would need to be considered by the auditor for planning, performing and reporting in an audit of internal financial controls over financial reporting under Clause (i) of Sub-section 3 of Section 143 of the 2013 Act. The applicable standards on auditing which, *inter alia*, need to be considered by the auditor when

² This definition of the term “Internal Controls Over Financial Reporting” has been reproduced from the Auditing Standard (AS) 5, *An Audit of Internal Control Over Financial Reporting that Is Integrated with An Audit of Financial Statements* issued by the Public Company Accounting Oversight Board (PCAOB), USA. The other text in this Guidance Note which has been reproduced from the aforesaid AS 5 of PCAOB has been identified in *italics* text in the relevant sections of the Guidance Note. The copyright of the so reproduced material rests with the PCAOB.

performing an audit of internal financial controls is given in the respective paragraphs of this guidance.

Specified date for reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting

38. The reporting by the auditor on internal financial controls under clause (i) of Sub-section 3 of Section 143 of the Act does not specify whether the auditor's report should state if such internal financial controls existed and operated effectively during the period under reporting of the financial statements or as at the balance sheet date up to which the financial statements are prepared.

39. Reporting on internal financial controls system is similar to reporting on operations of the company. Whilst the testing is carried out on the transactions recorded during the year, the reporting is as at the balance sheet date. For example, if the company's revenue recognition was erroneous through the year under audit but was corrected, including for matters relating to internal control that caused the error, as at the balance sheet date, the auditor is not required to report on the errors in revenue recognition during the year.

40. Attention is invited to paragraph (k) of Clause 57 of the Statement on the Companies (Auditor's Report) Order, 2003 issued by the Institute of Chartered Accountants of India on the auditor's responsibility for reporting on internal control and continuing failure in the internal control under CARO. The said paragraph states that "The auditor, while commenting on the clause, makes an assessment whether the major weakness noted by him has been corrected by the management as at the balance sheet date. If the auditor is of the opinion that the weakness has not been corrected, then the auditor should report the fact while commenting upon the clause."

41. Accordingly, the auditor should report if the company has an adequate internal financial controls system in place and whether the same was operating effectively as at the balance sheet date. It should be noted that when forming the opinion on internal financial controls, the auditor should test the same during the financial year under audit and not just as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher.

42. It may also be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Auditors' responsibility for reporting on internal financial controls over financial reporting in the case of unlisted companies

43. Under the Act, the directors statement of responsibility over establishing adequate internal financial controls and asserting operating effectiveness of such controls of the company is required only in case of listed companies. However, it appears that the auditor is required to report on adequacy and operating effectiveness of such internal financial controls even in the case of

unlisted companies since Clause (i) of Sub-section 3 of Section 143 of the 2013 Act does not specifically state that it is applicable only in the case of listed companies.

44. It may be noted that the management has the primary responsibility for the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error. Consequently, the responsibility of designing, implementing and maintaining appropriate internal financial controls also rests with the management. It may also be noted that Clause (vii) of Sub-section 4 of Section 177 of the Act states that every audit committee shall act in accordance with the terms of reference specified in writing by the board which shall, inter alia, include, "evaluation of internal financial controls and risk management systems". Further, Sub-section 5 of Section 177 provides that the audit committee may call for the comments of the auditors about internal control systems including the observations of the auditors and may also discuss any related issues with the internal and auditors and the management of the company.

In addition, Rule 8(5)viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

Consequently, even if a specific statement of responsibility of the directors over internal financial controls is not made in the board's report to the members of unlisted companies, ensuring adequacy and operating effectiveness of the internal financial controls system still remains with the management and the persons charged with governance in the company.

45. Therefore, this guidance also applies for reporting on internal financial controls in respect of unlisted companies and small companies and one person companies as defined in the Companies Act, 2013. Further, a small or a one person company typically possesses qualitative characteristics such as:

- a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- b) One or more of the following:
 - i. Straightforward or uncomplicated transactions;
 - ii. Simple record-keeping;
 - iii. Few lines of business and few products within business lines;
 - iv. Few internal controls;
 - v. Few levels of management with responsibility for a broad range of controls; or
 - vi. Few personnel, many having a wide range of duties.

It may, however, also be noted that these qualitative characteristics are not exhaustive, nor are they exclusive to small or one person companies. Also, all small and one person companies need not necessarily display all of these characteristics.³

³ Attention of the readers is also drawn to Section IG 19 of the Guidance Note.

Auditors' responsibility for reporting on internal financial controls over financial reporting in case of consolidated financial statements

46. Section 129(4) of the 2013 Act states that the provisions of the 2013 Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, *mutatis mutandis*, apply to the consolidated financial statements.

As such, on a strict reading of the aforesaid provision in the 2013 Act, it appears that the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements.

47. In the case of components included in the consolidated financial statements of the parent company, reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting would apply for the respective components only if it is a company under the 2013 Act. Accordingly, in line with the approach adopted in case of reporting on the consolidated financial statements on the clauses of section 143(3) and reporting on the Companies (Auditor's Report) Order, 2015 notified under section 143(11) of the 2013 Act, the reporting on adequacy and operating effectiveness of internal financial controls would also be on the basis on the reports on section 143(3)(i) as submitted by the statutory auditors of components that are Indian companies under the Act. The auditors of the parent company should apply the concept of materiality and professional judgment as provided in the Standards on Auditing and this Guidance Note while reporting under section 143(3)(i) on the matters relating to internal financial controls over financial reporting that are reported by the component auditors.

SECTION III: OVERVIEW OF INTERNAL CONTROLS AS PER SA 315

48. Components of Internal Control

Appendix I to SA 315 explains the five components of any internal control as they relate to a financial statement audit. The five components are:

- i. Control environment
- ii. Entity's risk assessment process
- iii. Control activities
- iv. Information system and communication
- v. Monitoring of controls

I. Control environment

49. The control environment encompasses the following elements:

- (a) **Communication and enforcement of integrity and ethical values.** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on

integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

- (b) **Commitment to competence.** Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
- (c) **Participation by those charged with governance.** An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
- (d) **Management's philosophy and operating style.** Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
- (e) **Organisational structure.** Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.
- (f) **Assignment of authority and responsibility.** The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) **Human resource policies and practices.** Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's risk assessment process

50. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance,

III.554 Auditing Pronouncements

assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

51. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- a) Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- b) New personnel. New personnel may have a different focus on or understanding of internal control.
- c) New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.
- d) Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- e) New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- f) New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- g) Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- h) Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- i) New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

II. Control activities

52. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

- a) Performance reviews. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

- b) Information processing. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
- c) Physical controls. Controls that encompass:
- The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
- d) Segregation of duties. Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

53. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

III. Information system, including the related business processes, relevant to financial reporting, and communication

54. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

55. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

- a) Identify and record all valid transactions.

III.556 Auditing Pronouncements

- b) Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- c) Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- d) Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- e) Present properly the transactions and related disclosures in the financial statements.

56. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

57. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

V. Monitoring of controls

58. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

59. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

60. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

61. Components of internal control and guidance provided

Refer Table below to see the mapping of internal control components with relevant references in this guidance:

Internal Control Component	Guidance reference*
Control environment	Paragraphs 88 – 93 – Identifying entity-level controls Paragraph 84 – Using the work of others
Risk assessment	Paragraph 76-78 – Role of risk assessment Paragraph 80-81 – Addressing the risk of fraud Paragraph 105-107 – Selecting controls to test Paragraphs 113, 119, 122 – Relationship of risk to the evidenced obtained Paragraph 124 and 127 – Special considerations for subsequent years' audit Paragraphs 144 and 145 – Subsequent events
Control activities	Paragraphs 100-104 – Understanding likely sources of misstatement Paragraphs 105 – 107 – Selecting controls to test IG 2.4 – Process flow diagrams IG 4 – Understanding IT Environment
Information system and communication	IG 2.4 – Process flow diagram IG 8 – Information Produced by the Entity (IPE) IG 2.9 to 2.13 – IPE Diagrams IG 9.3 and 9.4 - Situation in which service organisations are relevant for internal financial controls
Monitoring activities	Paragraphs 90, 91 and 93 – Identifying entity-level controls Paragraph 135 – Indicators of material weakness

* These references are not exhaustive. The purpose of these references is to help the reader understand the requirements of the components of internal control system in a better manner.

Effective Internal Control

62. The control environment sets the tone of an organization, influencing the control consciousness of its people. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

63. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not

effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness or significant deficiency in the entity's internal control.

64. An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

65. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Limitations of internal control system

66. Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives. Internal control systems are subject to certain inherent limitations, such as:

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

SECTION IV: TECHNICAL GUIDANCE ON AUDIT OF INTERNAL FINANCIAL CONTROLS OVER FINANCIAL REPORTING⁴

Introduction

67. This guidance provides direction that applies when an auditor is required to report under Clause (i) of Sub-section 3 of Section 143 of the 2013 Act on whether the company has in place adequate internal financial controls over financial reporting and the operating effectiveness of such controls.

68. Effective internal financial controls over financial reporting provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. If one or more material weaknesses exist, the company's internal financial controls cannot be considered effective.

69. Because a company's internal financial controls over financial reporting cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether the material weaknesses exist as of the balance sheet date. A significant deficiency or material weakness in internal financial controls over financial reporting may exist even when financial statements are not materially misstated.

70. This guidance establishes the fieldwork and reporting requirements applicable for expressing an audit opinion to internal financial controls over financial reporting.

71. The auditor should use the same system of internal financial controls over financial reporting to perform his or her audit of internal financial controls over financial reporting as management uses for its annual evaluation of the adequacy and effectiveness of the company's internal financial controls.

Combining the audits

72. The audit of internal financial controls over financial reporting should be combined with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

73. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously:

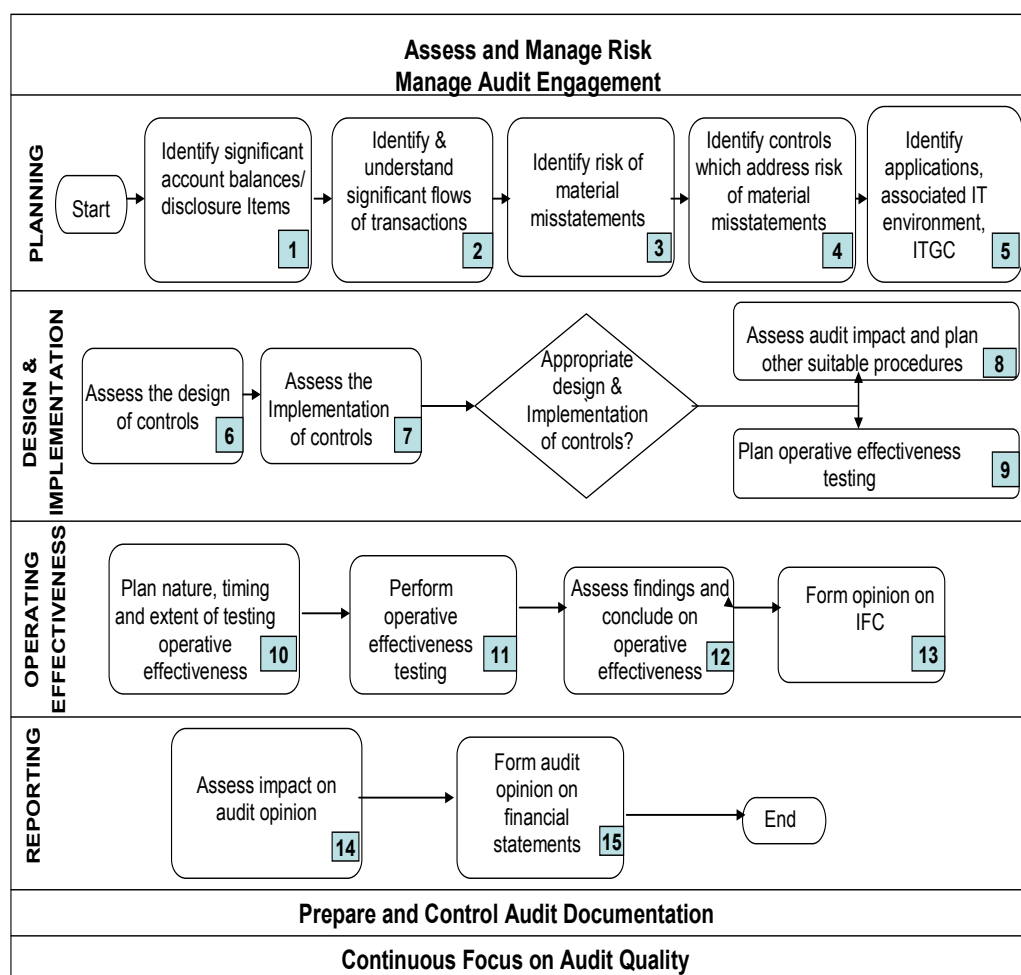
- To obtain sufficient evidence to support the auditor's opinion on internal financial controls over financial reporting as of year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

⁴ The text shown in *italics* in this Section of the Guidance Note has been reproduced from Auditing Standard (AS) 5, An Audit Of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements, issued by the Public Company Accounting Oversight Board (PCAOB), in June 2007. The copyright of the so reproduced material rests with the PCAOB.

III.560 Auditing Pronouncements

74. Obtaining sufficient evidence to support control risk assessments for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

Flowchart below Illustrates Typical Flow of Audit of Internal Financial Controls over Financial Reporting



Internal Financial Controls over Financial Reporting - Flowchart legends

Legend	Technical guidance / Implementation guidance reference
1	Paragraph 94-99 & IG 2
2	IG 2
3	Paragraph 100-104 & IG 2

4	Paragraph 105-107 & IG 2
5	IG 2 & IG 4
6	Paragraph 108-109, IG 10, IG 11 & IG 12
7	Paragraph 108-109, IG 10, IG 11 & IG 12
8	Paragraph 128-136
9	Paragraph 110-111 & IG 13
10	Paragraph 110-111, IG 13
11	Paragraph 128-136
12	IG 13
13	Paragraph 153 - 164
14	Paragraph 157 - 164
15	Paragraph 163 & IG 20

Planning the Audit

75. The auditor should properly plan the audit of internal financial controls over financial reporting and properly supervise any assistants. The activities will include pre-engagement activities such as agreeing the terms of the engagement. (Refer **Appendix I** for illustrative format of the engagement letter). When planning a combined audit of internal financial controls over financial reporting and financial statements, the auditor should evaluate whether the following matters are important to the company's financial statements and internal financial controls over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal financial controls over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organisation, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal financial controls over financial reporting;
- The auditor's preliminary judgements about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee or management by the auditor or the internal auditor;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal financial controls over financial reporting;

III.562 Auditing Pronouncements

- Preliminary judgements about the effectiveness of internal financial controls over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal financial controls over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's KYC guidelines; and
- The relative complexity of the company's operations.

Note: *Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralised accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.*

Role of Risk Assessment

76. Risk assessment underlies the entire audit process described by this guidance, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.

77. A direct relationship exists between the degree of risk that a significant deficiency or material weakness could exist in a particular area of the company's internal financial controls over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal financial controls over financial reporting will fail to prevent or detect a misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

*An illustrative list of risks of material misstatement, related control objectives and control activities is given in **Appendix IV**.*

78. *The complexity of the organisation, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.*

Further, the auditor needs to consider SA 315, for detailed procedures in connection with risk assessment.

Customising the Audit

79. *The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Customising is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex*

company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.

Addressing the Risk of Fraud

80. When planning and performing the audit of internal financial controls, the auditor should take into account the results of his or her fraud risk assessment. As part of identifying and testing entity-level controls, as discussed beginning at paragraph 88 of this Section, and selecting other controls to test, as discussed beginning at paragraph 105 of this Section, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include:

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

81. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal financial controls over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in SA 240 "The Auditor's Responsibilities Relating to Fraud in An Audit of Financial Statements".

Further the auditor would also need to consider the requirements of other guidance issued by ICAI for the procedures to be performed in connection with fraud risk factors.

Using the Work of Others (Refer IG 18)

82. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. SA 610 "Using the Work of Internal Auditors" and SA 620 "Using the Work of an Auditor's Expert" apply in a combined audit of internal financial controls over financial reporting and financial statements.

83. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the auditor when expressing an opinion on financial statements and internal financial controls over financial reporting. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of the internal auditors.

84. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work.

III.564 Auditing Pronouncements

Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

85. The extent to which the auditor may use the work of others in an audit of internal financial controls over financial reporting also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

86. In planning the audit of internal financial controls over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements as provided in SA 320 "Materiality in Planning and Performing an Audit".

Note: Since the audit of internal financial controls is in connection with the financial reporting, the concept of materiality will be applicable even in such audit. The auditor may consider materiality when he or she makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- (a) Determining the nature, timing and extent of risk assessment procedures;
- (b) Identifying and assessing the risks of material misstatement;
- (c) Identifying classes of transactions, account balances and disclosures that need to be considered for testing; and
- (d) Determining the nature, timing and extent of audit procedures.

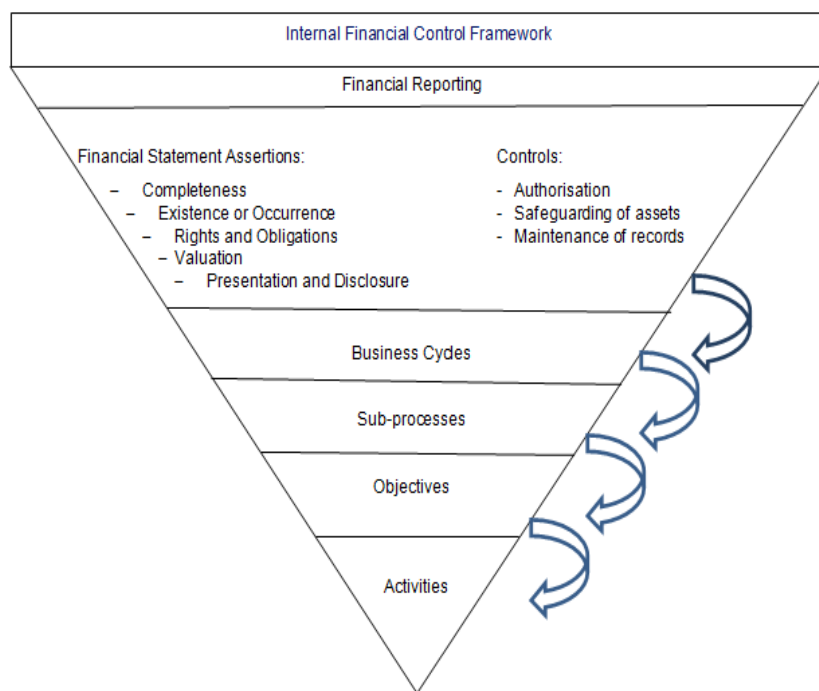
Using a Top-down Approach

87. The auditor should use a top-down approach to the audit of internal financial controls over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal financial controls over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the

auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Top-Down Approach to Internal Financial Controls Over Financial Reporting



Identifying Entity-level Controls (Refer IG 5, IG 19.7, IG 19.8, 19.15 & 19.20)

88. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal financial controls over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

89. Entity-level controls vary in nature and precision:

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor

III.566 Auditing Pronouncements

selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls when operating effectively, might allow the auditor to reduce the testing of other controls.
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

90. Entity-level controls include:

- Controls related to the control environment;
- Controls over management override;

Note: *Controls over management override are important to effective internal financial controls over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override. Similarly, in case of a small company as defined in the 2013 Act, since there is no requirement for an Audit Committee, the Board of Directors could be providing such detailed oversight that focuses on the risk of management override.*

- The company's risk assessment process;
- Centralised processing and controls, including shared service environments; (Refer IG 9)
- *Controls to monitor results of operations;*
- *Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;*
- *Controls over the period-end financial reporting process;*
- *Controls over recording of unusual transactions; and*
- *Policies that address significant business control and risk management practices.*

91. Control environment. Because of its importance to effective internal financial controls over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess:

- *Whether management's philosophy and operating style promote effective internal financial controls over financial reporting;*

- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

92. *Period-end financial reporting process. Because of its importance to the auditor's opinions on internal financial controls over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following:*

- *Procedures used to enter transaction totals into the general ledger;*
- *Procedures related to the selection and application of accounting policies;*
- *Procedures used to initiate, authorise, record, and process journal entries in the general ledger;*
- *Procedures used to record recurring and non-recurring adjustments to the annual and quarterly / interim financial statements / results, if any;*
- *Procedures for preparing annual and quarterly financial statements and related disclosures.*

93. *As part of evaluating the period-end financial reporting process, the auditor should assess:*

- *Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and interim financial statements;*
- *The extent of information technology ("IT") involvement in the period-end financial reporting process;*
- *Who participates from management;*
- *The locations involved in the period-end financial reporting process;*
- *The types of adjusting and closing entries; and*
- *The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.*

Note: *Because the annual period-end financial reporting process normally occurs after the balance sheet date, management's assessment of those controls usually cannot be tested until after the balance sheet date.*

Note: *The auditor should obtain sufficient evidence of the effectiveness of those interim controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the interim balance sheet dates for the purpose of evaluating the annual period-end financial reporting process. However, the auditor is not required to obtain sufficient evidence for each interim period financial reporting process individually, since the auditor would be reporting on the adequacy and operating effectiveness of the internal financial controls over financial reporting as at the year-end balance sheet date.*

Identifying significant accounts and disclosures and their relevant assertions

94. *The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include:*

- *Existence or occurrence;*
- *Completeness;*
- *Valuation or allocation;*
- *Rights and obligations;*
- *Assertions relating to presentation and disclosure*

95. *To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:*

- *Size and composition of the account;*
- *Susceptibility to misstatement due to errors or fraud;*
- *Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;*
- *Nature of the account or disclosure;*
- *Accounting and reporting complexities associated with the account or disclosure;*
- *Exposure to losses in the account;*
- *Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;*
- *Existence of related party transactions in the account; and*
- *Changes from the prior period in account or disclosure characteristics.*

96. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor should also determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

97. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal financial controls over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

Note: In the financial statements audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are determined not to be significant accounts, disclosures and relevant assertions.

98. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

99. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the financial statements of the company as a whole. Having made those determinations, the auditor should then apply the guidance provided in paragraph IG 1 for multiple locations scoping decisions.

Understanding likely sources of misstatement

100. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives:

- *Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorised, processed, and recorded; (Refer IG 2 and IG 3)*
- *Verify that he/she has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;*
- *Identify the controls that management has implemented to address these potential misstatements; and*
- *Identify the controls that management has implemented over the prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.*

*An illustrative list of risks of material misstatement, related control objectives and control activities is given in **Appendix IV**.*

101. Because of the degree of judgement required, the auditor should perform the procedures that achieve the objectives in paragraph 100 either by himself or herself or supervise the work of others who provide direct assistance to the auditor.

102. The auditor should also understand how Information Technology (IT) affects the company's flow of transactions. The auditor should apply the requirements of SA 315, which discuss the effect of information technology on internal financial controls and the risks to assess. (Refer IG 4)

Note: *The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this guidance.*

103. Performing walkthroughs. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 100. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until

III.570 Auditing Pronouncements

it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls. (Refer IG 12)

104. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting controls to test

105. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

106. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

107. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, detective control).

Testing controls-testing design effectiveness (Refer IG 11 and IG 12)

108. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. This would also enable the auditor to conclude if the company has *an adequate internal financial controls system over financial reporting in place*.

Note: *A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organisation. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.*

109. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant

documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing controls-testing operating effectiveness (Refer IG 13)

110. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: *In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.*

111. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of risk to the evidence to be obtained

112. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a significant deficiency or material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Note: *Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's overall internal financial controls over financial reporting. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.*

113. Factors that affect the risk associated with a control include:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;

III.572 Auditing Pronouncements

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance; (Refer IG 6)
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls); (Refer IG 7 and IG 8)
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

Note: *A less complex company or business unit with simple business processes and centralised accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.*

- *The complexity of the control and the significance of the judgements that must be made in connection with its operation.*

Note: *Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.*

114. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: *Because effective internal financial controls over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives over the period-end financial reporting process, an individual control does not necessarily have to operate without any deviation to be considered effective.*

115. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: *Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.*

116. Nature of tests of controls. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are

presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control. (Refer IG 10)

Note: *Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.*

117. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: *A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.*

118. Timing of tests of controls. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the balance sheet date provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the balance sheet date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness. (Refer IG 16)

119. Prior to the balance sheet date, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal financial controls over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (Refer IG 17)

120. Extent of tests of controls. The more extensively a control is tested, the greater the evidence obtained from that test. (Refer IG 14)

121. Roll forward procedures. When the auditor reports on the effectiveness of controls as of the balance sheet date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary. (Refer IG 15)

122. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

- The specific control tested prior to the balance sheet date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;

III.574 Auditing Pronouncements

- The length of the remaining period; and
- The possibility that there have been any significant changes in internal financial controls subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special considerations for subsequent years' audits (Refer IG 16 and IG 20)

123. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal financial controls over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 112 to 122.

124. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 113 and the following:

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

125. After taking into account the risk factors identified in paragraphs 113 and 124, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

When planning the nature, timing and extent of testing for reporting on internal financial controls over financial reporting in a subsequent year, the auditor is normally not expected to adopt a rotation / cyclical plan for testing controls i.e., the auditor cannot choose to defer testing of certain controls for the reason that they were tested in the immediate previous year. Rotation / cyclical plan for testing internal financial controls over financial reporting may be permitted in limited circumstances as more fully described in IG 16.

126. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph IG 7.6.

127. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed or change the combination of procedures used.

Evaluating identified deficiencies

128. The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are significant

deficiencies or material weaknesses as of the balance sheet date. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a significant deficiency.

Note: For purpose of this guidance,

- A 'deficiency' in internal financial control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- A 'significant deficiency' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting that is important enough to merit attention of those charged with governance since there is a reasonable possibility that a misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.
 - A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
 - A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.
- A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

129. The severity of a deficiency depends on:

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

130. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

131. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;
- The subjectivity, complexity, or extent of judgement required to determine the amount involved;
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;

III.576 Auditing Pronouncements

- The interaction of the deficiencies; and
- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

132. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

133. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

134. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a significant deficiency or material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weakness

135. Indicators of material weaknesses in internal financial controls over financial reporting include:

- Identification of fraud, whether or not material, on the part of senior management;
- Errors observed in previously issued financial statements in the current financial year;
- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal financial controls over financial reporting; and
- Ineffective oversight of the company's external financial reporting and internal financial controls over financial reporting by the company's audit committee.

136. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor should also determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions

are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weaknesses.

Communicating Certain Matters

137. The auditor must communicate, in writing, to management and those charged with governance all material weaknesses and any deficiencies, or combinations of deficiencies that are significant deficiencies identified during the audit. Where possible, the written communication should be made prior to the issuance of the auditor's report on internal financial controls over financial reporting to provide an opportunity for the company to remediate the material weakness. If such remediation is done before or as at the balance sheet date, the auditor could test the same before forming his/her final opinion.

138. Based on an evaluation of the implementation of the components of internal control which make up the system of internal financial controls over financial reporting established by the company, if the auditor concludes that the oversight of the company's external financial reporting and internal financial controls over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

139. The auditor should also communicate to management, in writing, all deficiencies in internal financial controls over financial reporting (i.e., those deficiencies in internal financial controls over financial reporting that are of a lesser magnitude than significant deficiency) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organisation.

140. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal financial controls over financial reporting of which he or she is aware.

141. Because the audit of internal financial controls over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a significant deficiency, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

142. With respect to communications relating to the audit of internal financial controls over financial reporting, the auditor should also consider and suitably adapt the requirements and principles of SA 260 "Communication with Those Charged with Governance" and SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management".

143. When auditing internal financial controls over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under the Companies Act, 2013 and SA 240 and SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements".

Subsequent Events

144. Changes in internal financial controls over financial reporting or other factors that might significantly affect internal financial controls over financial reporting might occur subsequent to the date as of which internal financial controls over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 150.

145. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal financial controls over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- *Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,*
- *Regulatory agency reports on the company's internal financial controls over financial reporting, and*
- *Information about the effectiveness of the company's internal financial controls over financial reporting obtained through other engagements.*

146. The auditor might inquire about and examine other documents for the subsequent period. SA 560 "Subsequent Events", provides direction on subsequent events for a financial statement audit that may also be helpful to the auditor performing an audit of internal financial controls over financial reporting.

147. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal financial controls over financial reporting as of the balance sheet date, the auditor should issue an adverse opinion on internal financial controls. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal financial controls over financial reporting, the auditor should disclaim an opinion.

148. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal financial controls reporting over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects.

149. After the issuance of the report on internal financial controls over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent

information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in SA 560.

Obtaining Written Representations

150. *In an audit of internal financial controls over financial reporting, the auditor should obtain written representations from management:*

- *Acknowledging management's responsibility for establishing and maintaining adequate internal financial controls over financial reporting that were operating effectively;*
- *Stating that management has performed an evaluation and made an assessment of the adequacy and effectiveness of the company's internal financial controls over financial reporting and specifying the control criteria;*
- *Stating that management did not use the auditor's procedures performed during the audits of internal financial controls over financial reporting or the financial statements as part of the basis for management's assessment of the adequacy and effectiveness of internal financial controls over financial reporting;*
- *Stating management's conclusion, as set forth in its assessment, about the adequacy and effectiveness of the company's internal financial controls over financial reporting based on the control criteria as of the balance sheet date;*
- *Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal financial controls over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal financial controls over financial reporting;*
- *Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal financial controls over financial reporting;*
- *Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 137 and 139 have been resolved, and specifically identifying any that have not; and*
- *Stating whether there were, subsequent to the date being reported on, any changes in internal financial controls over financial reporting or other factors that might significantly affect internal financial controls over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.*

SA 580 "Written Representations" explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter. (Refer **Appendix II** for illustrative format of the management representation letter)

III.580 Auditing Pronouncements

151. Inability to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. When the scope of the audit is limited, the auditor should either disclaim the audit opinion or resign from the engagement.

152. Since the primary responsibility for establishing and maintaining an adequate internal financial controls system over financial reporting is that of the management and the board of directors of the company, the auditor should ensure that the board of directors approving the financial statements of the company also approve the management assertion and conclusion on the adequacy and operating effectiveness of internal financial controls over financial reporting and also take on record the deficiencies, significant deficiencies and material weaknesses identified by the management, internal auditors and the auditor.

Note: Since the board report under Section 134 of the Act, which would include the directors responsibility statement, inter alia, on internal financial controls, may be prepared after the date of the audit report, it is essential that the auditor obtains the assertion of the board of directors on the internal financial controls over financial reporting prior to issuance of the audit report.

Forming an Opinion (Refer IG 20)

153. The auditor should form an opinion on the adequacy and operating effectiveness of internal financial controls over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal financial controls over financial reporting and evaluate control deficiencies identified in those reports.

154. After forming an opinion on the adequacy and operating effectiveness of the company's internal financial controls over financial reporting, the auditor should evaluate the disclosures that the management and board of directors is required to make, under the Act on internal financial controls. In this connection, the auditor should apply the requirements of SA 720 "The Auditor's Responsibility In Relation To Other Information In Documents Containing Audited Financial Statements" for matters relating to internal financial controls over financial reporting included in the documents of the Company.

155. If the auditor determines that any required elements of the board's report on internal financial controls over financial reporting are incomplete or improperly presented, the auditor should follow the requirements of SA 720.

156. The auditor may form an opinion on the adequacy and operating effectiveness of internal financial controls over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement.

Reporting on Internal Financial Controls over Financial Reporting

157. The auditor's report on the audit of internal financial controls over financial reporting must include the following elements:

- a. *A title that includes the word independent;*
- b. *A statement that management is responsible for maintaining adequate and effective internal financial controls over financial reporting and for assessing the adequacy and effectiveness of internal financial controls over financial reporting as per the meaning of internal financial controls provided in the Act;*
- c. *An identification of the benchmark criteria used by the management for establishing internal financial controls over financial reporting;*
- d. *A statement that the auditor's responsibility is to express an opinion on the company's internal financial controls over financial reporting based on his or her audit;*
- e. *A statement that the audit was conducted in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and the Standards on Auditing, to the extent applicable to an audit of internal financial controls over financial reporting, both issued by the Institute of Chartered Accountants of India;*
- f. *A statement that the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and Standards on Auditing require that the auditor plan and perform the audit to obtain reasonable assurance about whether adequate and effective internal financial controls over financial reporting were maintained in all material respects;*
- g. *A statement that an audit includes obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the adequacy and operating effectiveness of internal control over financial reporting based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;*
- h. *A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;*
- i. *A paragraph stating that, because of inherent limitations, internal financial controls over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;*

Note: In an audit of financial statements, it is presumed that the going concern assumption for the company is appropriate and the auditor evaluates the appropriateness of such assumption. In case such assumption is not appropriate or a material uncertainty exists, the auditor is required to comply with the requirements of SA 570 "Going Concern". Correspondingly, in an audit of internal financial controls over financial reporting, the auditor needs to make appropriate disclosures to state the inherent limitations on internal financial controls over financial reporting and the limitations in consideration of such controls operating as at the balance sheet date for the future operations of the company.

- j. *The auditor's opinion on whether the company maintained, in all material respects, adequate internal financial controls over financial reporting and whether they were operating effectively as of the balance sheet date, based on the control criteria;*
- k. *The signature of the auditor with firm name, where applicable;*

I. The place and date of the audit report.

Audit Report

158. The auditor may issue separate reports on the company's financial statements and on internal financial controls over financial reporting.

159. Examples of separate unmodified report on internal financial controls over financial reporting in the case of the standalone and consolidated financial statements are given in **Appendix III – Example 1 and 5**, respectively.

160. Examples of separate modified report on internal financial controls over financial reporting in the case of the standalone financial statements are given in **Appendix III – Examples 2 to 4**.

Modified Opinion

161. Paragraphs 128 to 136 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must evaluate the need to express a modified opinion – qualified or adverse on the company's internal financial controls over financial reporting, unless there is a restriction on the scope of the engagement.

162. When expressing a modified opinion on internal financial controls because of material weakness, the auditor's report must include:

- The definition of a material weakness as provided in this Guidance Note.
- A statement that a material weakness has been identified.
- A description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness.

163. The auditor should determine the effect his or her modified opinion on internal financial controls over financial reporting has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the modified opinion on internal financial controls over financial reporting. (Refer IG 20)

***Note:** When the auditor issues a separate report on internal financial controls over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 160 and 162. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.*

Report Date

164. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Because the auditor's reporting on internal financial controls over financial reporting is specified in the same Section as that of the opinion on financial statements viz. Section 143(3) of the Act, the date of the audit report

on internal financial controls over financial reporting should be the same as that of the date of the audit report on the financial statements.

Audit Documentation

165. The auditor should document the work performed on internal financial controls over financial reporting such that it provides:

- (a) A sufficient and appropriate record of the basis for the auditor's report; and
- (b) Evidence that the audit was planned and performed in accordance with this guidance, applicable Standards on Auditing and applicable legal and regulatory requirements.

In this regard, the auditor should comply with the requirements of SA 230 "Audit Documentation" to the extent applicable.

Considerations for Joint Audits and Branch Audits

166. Where applicable, the auditor should comply with the requirements of SA 299 "Responsibility of Joint Auditors" to the extent applicable when performing an audit of internal financial control over financial reporting. The following may be considered in case of both joint audits and branch audits, as applicable:

- (a) Division of work
- (b) Coordination
- (c) Relationship among joint auditor / branch auditor
- (d) Reporting responsibilities

Considerations for using this Guidance for Internal Financial Controls Over Financial Reporting Assessments on behalf of Company's Management

167. Any member or other professionals should consider this guidance to the extent applicable in carrying out internal financial control over financial reporting assessments on behalf of the company's management.

SECTION V :IMPLEMENTATION GUIDANCE⁵

IG 1 Multiple Locations Scoping Decisions (Refer Paragraph 99):

IG 1.1 In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with

⁵ The text shown in *italics* in this Section of the Guidance Note has been reproduced from the following documents issued by the Staff of the Public Company Accounting Oversight Board (PCAOB):

- Staff Views - An Audit Of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements: Guidance For Auditors Of Smaller Public Companies (*January 2009*)
- Staff Audit Practice Alert No. 11, Considerations for Audits of Internal Control Over Financial Reporting (*October 2013*)

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III.584 Auditing Pronouncements

the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

Note: *The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's financial statements.*

IG 1.2 In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's financial statements. In lower-risk locations or business units, the auditor might first evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organisation, provides the auditor with sufficient evidence.

IG 1.3 In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and plan the number of locations or business units at which the auditor would otherwise need to perform auditing procedures, subject to compliance with the requirements of SA 610 "Using the Work of Internal Auditors".

IG 1.4 The direction regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

IG 1.5 Special Situations: The scope of the audit should include businesses that are acquired on or before the balance sheet date and operations that are accounted for as discontinued operations on the balance sheet date.

IG 2 Process Flow Diagrams (Refer Paragraph 100)

Understanding process flows

IG 2.1 To enhance the understanding of the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives:

- *Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorised, processed, and recorded;*
- *Verify that he/she has identified the points within the company's processes at which a misstatement—including a misstatement due to fraud—could arise that, individually or in combination with other misstatements, would be material;*
- *Identify the controls that management has implemented to address these potential misstatements; and*
- *Identify the controls that management has implemented over the prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.*

Information system relevant to financial reporting

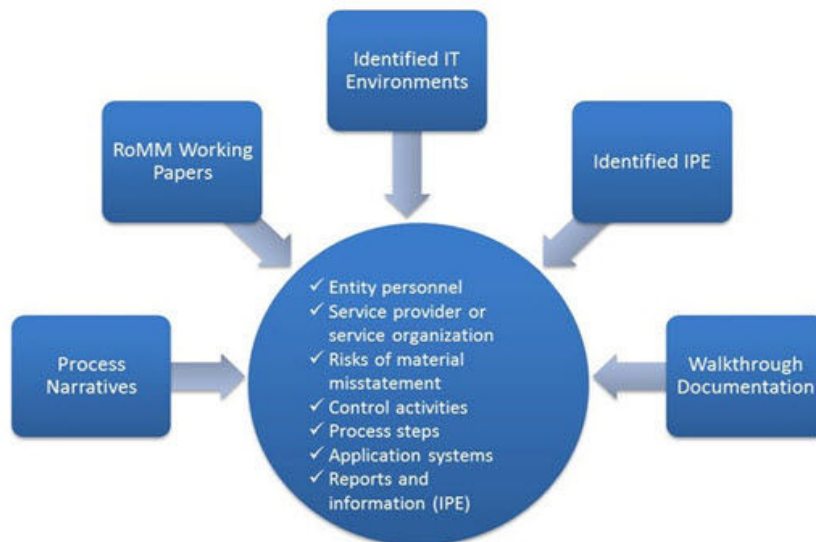
IG 2.2 The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

- The classes of transactions in the company's operations that are significant to the financial statements;
- The procedures, within both automated and manual systems, by which those transactions are initiated, authorised, processed, recorded, and reported;
- The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorise, process, and record transactions;
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements; and
- The period-end *financial reporting process*.

Process flow diagrams

IG 2.3 Process flow diagrams may be a helpful form of documentation for auditors to depict the process to initiate, authorise, process, record and report transactions; the points within the process at which misstatements could occur; and control activities that are designed to prevent or detect such misstatements, including providing greater transparency to segregation of duties. These diagrams also depict the relevant systems and Information Produced by the Entity (IPE).

Refer figure below on sources and linkage of information for internal financial controls purposes:



IG 2.4 When considering and reviewing the relevant information to developing process flow diagrams, the following questions may be helpful:

- Who is involved in the process (e.g., departments, roles, and people)?
- Are there segregations of duties that are relevant to the process?
- What is the general objective of the processes and what are the related sub-processes?
- When does the process occur?
- Does the process involve, or impact, multiple locations?

III.586 Auditing Pronouncements

- What are the tasks within the process and in what sequence do they occur?
- What are the points in the process at which a misstatement, including a misstatement due to fraud, could arise?
- What control activities address the risks?
- What IPE is involved?
- How are application systems involved within the process?

Audit-specific Elements to be Added to the Process Flow Diagram

IG 2.5 Additional detail may be added to represent the audit-specific elements. The following are the general steps for consideration:

1. Insertion of risks of material misstatement
 - a. The auditor may insert symbols for risk of material misstatement at the point(s) in the process flow where the risk is present. It is possible that, due to the nature of the risk of material misstatement, it may appear at multiple points in the process flow diagram.
 - b. The auditor may use different symbols for significant and normal risk of material misstatement as necessary.
2. Attaching control activity symbols
 - a. Symbols may be placed for control activity that address risks of material misstatement on the diagram.
 - b. Automated and manual control symbols may be used as necessary
3. Identification of applications in the process flow diagram
 - a. If a task relies on an application system when performing an action, the auditor may use a symbol for such applications on the diagram
 - b. If formatting and space allows, the auditor may attach the application symbol directly on the task which it relates
4. Associating the IPE symbol where appropriate
 - a. If IPE is used in the execution of a control activity or IPE that is produced as part of the process that is important to the audit (e.g., IPE that an auditor uses in his or her substantive procedures), the auditor may attach a separate symbol for the IPE as a document symbol.

System Overview Diagrams

IG 2.6 The information system relevant to financial reporting can be complex; a visual representation may assist the auditor in understanding how information flows between systems related to the financial transactions of the entity.

IG 2.7 For complex entities, several system overview diagrams may be useful to depict the different systems relevant for a particular process (or across processes). A system overview diagram may also be useful when system complexities and interrelationships demand more visual space to depict the systems that are relevant to the process.

IG 2.8 The following types of information may be useful in this process:

- Applications relevant to the audit;
- Service providers, or service provider systems, involved in entity processes that are determined to be relevant to the audit (e.g., a payroll service organisation and the outsourced systems relevant to the process).

IPE diagrams

IG 2.9 When a control activity is dependent upon IPE that is generated from systems or other sources, it is important that the auditor understands what could go wrong in the generation of the IPE. Illustrative diagrams that depict the auditor's understanding of the report logic, parameters, and source data may be helpful when trying to understand and articulate the risks related to IPE.

IG 2.10 It may be helpful to involve Information Technology (IT) specialists in the creation of IPE diagrams, especially if the IPE is system generated, as much of the information may be generated from the IT systems of the entity. It is important that IT specialists collaborate with the auditors who use the IPE for audit purposes so everyone gains an appropriate understanding of the purpose and intended use of the IPE.

IG 2.11 IPE may be relevant to the audit due to its relationship with the auditor's tests of controls or substantive procedures. The following are the general reasons that IPE is relevant to the audit:

- IPE is used by entity personnel to perform a relevant control.
- IPE is used by the auditor to test a relevant control.
- IPE is used by the auditor to perform substantive procedures.

IG 2.12 Regardless of the use of the IPE in the context of an audit, the auditor may consider creating IPE diagrams to document his or her understanding of the IPE and assist in determining appropriate procedures to test the accuracy and completeness of the information.

IG 2.13 The following general steps to be performed by auditors to build an IPE diagram assume that the auditor has already identified relevant IPE to the audit:

Step 1 — Identification of and Understanding Report Logic and Parameters

The auditor should begin by obtaining an understanding of the business purposes of the IPE. Before gaining a detailed understanding of the parameters and report logic, it may be helpful to understand what specific information in the IPE is relevant to the audit. Auditors may then proceed to identify inputs that could impact the IPE and determine how the IPE is used during the performance of the control activity.

IPE parameters — the criterion for selecting data, such as date ranges, company codes, or specified thresholds:

- If the IPE can be modified by the user to produce a desired or different result, then parameters most likely are used in the generation of the IPE.
- The auditor should determine what parameters are available and have a direct impact to the information that is produced.

III.588 Auditing Pronouncements

IPE report logic — the computer code that contains the algorithms for creating the report:

- The auditor should have discussions with the business users and technical owners of the IPE. He should understand what information is generated and gain an understanding of how the logic was developed to create the output.
- The auditor should gain an understanding if the IPE is generated through custom or standard reporting capabilities of the system.

The auditor should identify if there are general IT controls that address the risks arising from IT relevant to the system that generates the IPE.

Step 2 — Identification and Understanding Source Data

After understanding the report logic associated with IPE, it is also necessary for the auditor to consider the accuracy and completeness of source data. As the engagement teams begin to understand the source data used in the generation of a report, it is important that they consider the accuracy of the data for their intended use. The overall goal of developing IPE diagrams is to help understand and evaluate how the IPE might be inaccurate or incomplete. If the source data is not appropriate for its intended use, indicate the same in the IPE diagram and describe further details in annotation to inform others as to the challenges that might exist.

It is also important for the auditor to determine the origination of the IPE data source (e.g., tables), if applicable, and annotate such in the IPE diagram.

For example, while IPE information may be extracted from a single reporting table in a system, the reporting table may have been created by consolidating information from several other system tables. Depicting the relationships between the tables that ultimately generate the IPE is important when understanding and evaluating the risks that the IPE might be inaccurate or incomplete because of issues related to source data. Such interrelationship of the source data in the IPE diagram should be depicted by the auditor.

Step 3 — Building the IPE Diagrams

After the IPE parameters, report logic and source data have been understood, the auditor can develop the IPE diagram.

The following basic elements may be depicted in the diagram to represent the auditor's understanding of the IPE:

- IPE parameters
 - Identification of relevant parameters that impact the results of the IPE.
 - Common parameter combinations used to generate IPE (if there are recurring uses).
- IPE logic
 - Identification of standard or custom IPE logic.
 - Location information on where the source logic is maintained in the system.

- If a benchmarking strategy is used to test logic, identification of the date that logic was last changed.
- Information that indicates whether general IT controls are relevant.
- IPE source data
 - Relevant application systems.
 - Sources of information used to generate IPE (e.g., system tables).
 - Information that indicates whether general IT controls are relevant.
 - If general IT controls are not relevant, document alternative methods for validating the accuracy and completeness of the data.
- Reference to IPE on process flow diagram, if applicable.

Automated control diagrams

IG 2.14 When automated control activities exist, it may be relatively easy to describe broadly how they function; however, it can be difficult to describe the detailed attributes of the control that are relevant to the audit and how they operate in sufficient detail to facilitate designing effective tests of such controls. Pictorial diagrams may enhance the auditor's understanding of how automated control activities are designed to address risks of material misstatement, and may therefore better facilitate planning effective tests of such controls. The purpose of the automated control diagram is to demonstrate how the control operates logically to prevent or detect risks of material misstatement from occurring.

The following general steps are helpful into building an automated control diagram:

Step 1 — Understanding Relevant Automated Controls

The auditor should begin by obtaining an understanding of the purposes of the automated control; he may consider performing the following:

- Have discussions with the business process owners and technical owners who interact with the automated control.
- Understand what the system is evaluating to prevent or detect errors from occurring. Identify if the automated control logic can be applied differently across the entity based on changing the configurations.
- Identify if there are general IT controls that address the risks arising from IT relevant to the application system with automated controls.

Step 2 — Building the Automated Control Diagram

After the automated controls are understood, the automated control diagram can be developed. The following basic elements may be depicted on the diagram to represent the auditor's understanding of the automated control:

- Control activity reference

III.590 Auditing Pronouncements

- Depicting control activities in the form of task boxes with a description of the action enforced by the automated control.
- Connecting the automated control symbol to the task box and use the same reference number that is depicted on the process flow diagram.
- System references
 - Depicting systems on the diagram when associated with a control activity task.
 - If data sources are shown in the diagram, depicting the source system.
- Automated control logic
 - The auditor should document what the automated control relies upon from a logic perspective to perform the desired action.
 - The auditor should illustrate what happens as a result of the automated control; decision boxes show what the possible paths might be based on the conditions that could be met.

Validate understanding

IG 2.15 A final step in developing the process flow diagrams, as well as any other supplemental diagrams, is to validate the auditor's understanding and determine whether the diagrams are accurate and complete for their intended purpose. Because processes can be complex and multiple information sources may be used in the development of supporting diagrams, it is important to validate the consistency of the diagrams with other sources of information used during the audit to determine that the auditor's understanding is consistent with respect to the identified risks of material misstatement, control activities, and IPE.

Figure



The auditor's process flow diagrams may also be reviewed with the entity personnel to validate that they accurately represent the entity's processes. Discussions with the entity using graphical representations of their process flows may lead to further enhancement of the auditor's understanding of the entity, their flow of transactions, and the likely sources of misstatement (for a combined audit of internal financial controls over financial reporting and financial statements), and in some cases might necessitate revisions to the auditor's first drafts of the process flow diagrams.

As part of the risk assessment procedures, evaluate process flow diagrams, and other supplemental diagrams, on an on-going basis and update as necessary. As the entity evolves and changes its systems, controls, and business processes, the risks of material misstatement might change, thereby leading to an update of the auditor's process flow diagrams.

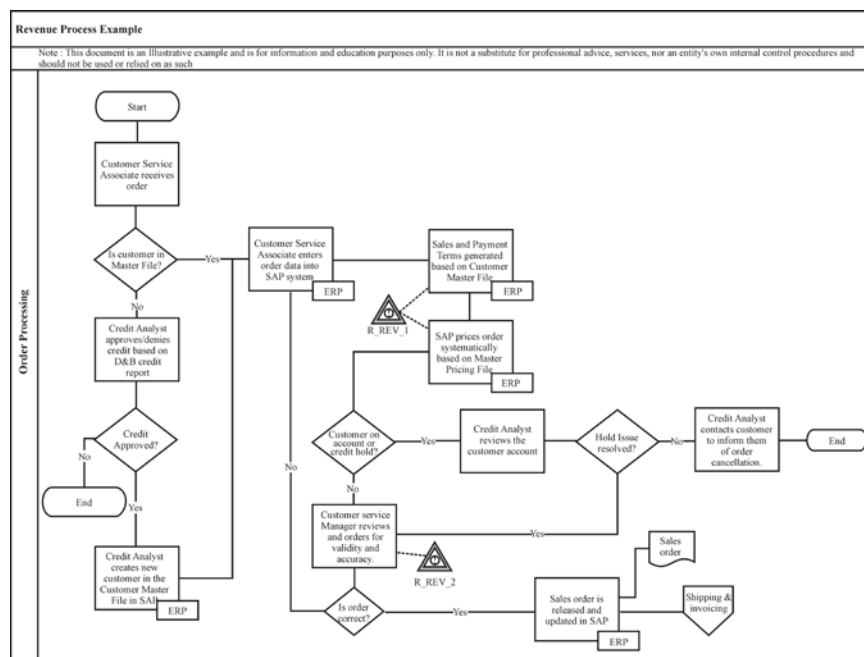
Illustrative example of process flow documentation for revenue business cycle

IG 2.16 Below is the detailed illustrative example of process flow diagrams for the Revenue process (which assumes an automated application system (ERP) used by the entity). The Revenue process covers the following sub-processes: Order Processing, Shipping and Invoicing, and Sales Returns. This illustrative example consists of three process flow diagrams and related narratives:

- Diagram 1 — Order Processing
- Diagram 2 — Shipping and Invoicing
- Diagram 3 — Sales Returns
- Revenue Narrative 1 — Order Processing
- Revenue Narrative 2 — Shipping and Invoicing
- Revenue Narrative 3 — Sales Returns

Diagram 1 — Order Processing

III.592 Auditing Pronouncements



Revenue Narrative 1 — Order Processing

Orders can be received via fax, mail, email, or phone. Customer Service Associates are responsible for monitoring incoming orders that arrive at the Business Centre. All faxes and postal mail are electronically converted by Customer Service Associates. Phone-based orders are directed to a central call number which rings the next available Customer Service Associate to take order information.

All orders must be created with reference to a customer that is established in the customer master file within SAP. If an order is received for a non-existent account, the new account procedure is followed, whereby a Credit Analyst reviews credit worthiness based on a Dun & Bradstreet credit report. In the event that a decision is taken to not extend credit, the processing of the order ends and the customer is contacted to inform them of the credit decision. If credit is extended to the customer, the Credit Analyst creates a new customer in the customer master file and notifies the Customer Service Associates to process the order.

When entering an order, "Sold to" and "Ship to" fields must be populated with a valid customer number that matches an existing customer number established in the customer master file. Sales and payment terms are automatically populated through the information contained in the customer master file in SAP (R_REV_1). All line items on the sales order are systematically populated based on the information in the master pricing file (R_REV_1).

Sales orders are configured with the following key mandatory fields: Sales Order Type (Rush Order or Stock Order), Order Source (fax, mail, email, phone), Sales Organisation, Sold to/Ship to account numbers, item quantities, material numbers, and purchase order number. The balance of the information is automatically extracted from the customer master or pricing master file records. Sales to customers with non-standard payment or shipping terms are automatically flagged in SAP;

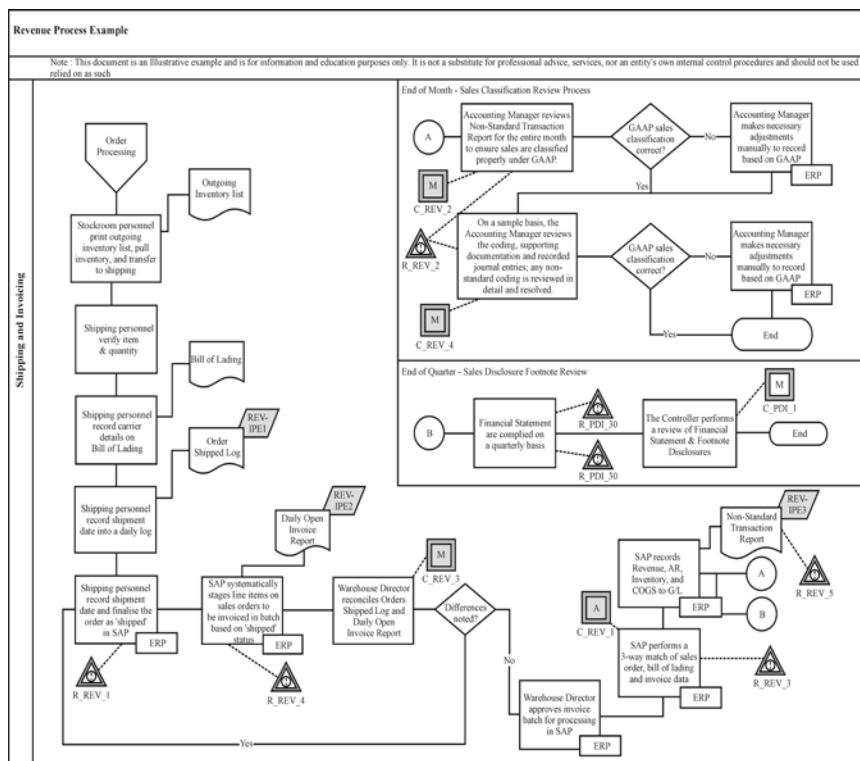
the flags are used in the shipping and invoicing process to generate exception reports for management to review. Pricing for each customer may be different based on negotiated contracts which are configured against the master pricing file with customer-specific discounts applied.

For orders on hold due to an account or credit hold, the credit department is notified. A Credit Analyst will review the hold and make a determination if the hold can be resolved. If the hold cannot be resolved, the Credit Analyst will contact the customer and notify them of order cancellation, ending the order entry process. If the hold can be resolved after investigation, the Credit Analyst will release the hold and submit the order to the Customer Service Manager to review. All processed orders must be reviewed and approved by the Customer Service Manager prior to being submitted to the shipping and invoicing process. If any errors are noted, they are resolved by the Customer Service Associates and resubmitted through the process. After the order is approved, the sales order is released and updated in SAP (R_REV_1).

The following is the IPE identified in the process flow:

- Orders Shipped Log (REV-IPE1)

Diagram 2 — Shipping and Invoicing



Revenue narrative 2 — Shipping and Invoicing

After the sales order is approved, the data is transferred automatically from the order entry system to the shipping and invoicing modules in SAP. Outgoing inventory lists are printed by the

III.594 Auditing Pronouncements

stockroom personnel. Outgoing inventory list quantities are populated systematically based on information defined in the approved sales orders.

The product is pulled from the warehouse by shipping personnel based on the information defined on the outgoing inventory lists. Shipping personnel will verify the information, such as item and quantity, and then package the items in preparation of shipment.

After the order is prepared for shipment, the bill of lading is printed with the carrier information recorded on the document; a carbon copy is forwarded on to shipping data entry personnel where the order is confirmed as shipped, completing the shipping process within the system (R_REV_1). Shipments of goods to customers are logged just prior to marking the orders as shipped in SAP; this is completed by taking carbon copies of the bill of lading documents and manually logging them in a spreadsheet that is maintained by the shipping clerks. The spreadsheet is referred to as the "Orders Shipped Log."

Once marked as shipped, line items in the sales order will change automatically in the system, which will result in closing the shipped lines and staging of the line items to be invoiced (R_REV_4). Only the lines on the sales order that ship will be invoiced. Open lines are back-ordered and will remain open until those items are shipped. The only other way to close a line on an order is to reject the line(s), which requires approval by a Customer Service Manager.

The SAP system compiles the staged invoices on a daily basis in a "Daily Open Invoice Report." The Orders Shipped Log and the Daily Open Invoice Report are both reviewed by the Warehouse Director on a daily basis to validate that all orders shipped have also been included in the invoicing batch. The Warehouse Director matches the shipments recorded in the Daily Open Invoice Report to the shipments logged in the manual Orders Shipped Log as being shipped to a customer (C_REV_3). If differences are noted, the Warehouse Director works with shipping personnel to ensure shipments are recorded in the system accurately. If no differences are noted, the batch is approved in SAP for invoice processing.

Invoicing is performed nightly in SAP through a systematic batch process. The SAP system performs a 3-way match; invoices can only be processed when there is a systematic matching of the purchase order, bill of lading/shipped status, and completing a 3-way match to generate the invoice (C_REV_1 | R_REV_3). The invoice generation process updates the general ledger, records the sale (recognises the revenue) and the receivable, relieves the inventory, and records cost of goods sold. As part of the nightly batch process, the SAP system generates a report that lists every flagged transaction that contained non-standard sales or shipping terms. This report is called the "Non-standard Transaction Report" (R_REV_5).

Revenue is recognised at the time of invoicing because the Company's standard sales terms are defined as free on board (FOB) shipping point. At the end of the month, the Accounting Manager reviews all non-standard transaction reports on a daily basis that were generated during the month; any non-standard sales terms (e.g., FOB destination) are reviewed in detail to ensure sales are classified properly under GAAP (C_REV_2 | R_REV_1). If corrections are necessary, the Accounting Manager makes manual adjustments to reflect proper GAAP classification of the transaction. After non-standard terms are reviewed, the Accounting Manager samples 50 sales transactions to evaluate the coding, supporting documentation, and journal entries made to the

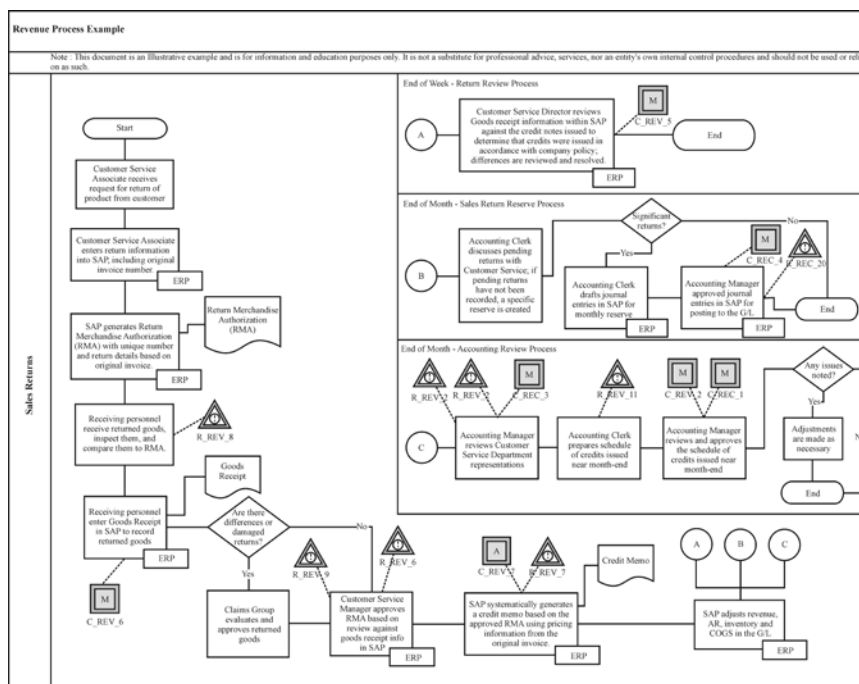
general ledger for all sales that are booked; any non-standard coding is reviewed in detail and resolved to ensure sales are classified properly under GAAP (C_REV_4 | R_REV_1). If corrections are necessary, the Accounting Manager makes manual adjustments necessary to reflect proper GAAP classification of the transaction.

On quarterly basis, once the financial statements have been compiled, the Controller performs a review of the financial statements, including all footnote disclosures. Included in this review are the sales-related disclosures in the footnotes of the financial statements. As part of this review, the Controller checks references to supporting documents (R_PDI_38 | R_PDI_39 | C_PDI_1).

The following is the IPE identified in the process flow:

- Daily Open Invoice Report (REV-IPE2)

Diagram 3 — Sales Returns



Revenue narrative 3 — Sales returns

Customer Service Associates receive requests for return of product. Customer Service Associates enter information into SAP at the time of request and use the original invoice number as a unique lookup code to generate base information for the return. SAP generates the Return Merchandise Authorisation (RMA) with unique number and listing of material(s) requested to be returned, with pricing obtained from original invoice data.

Upon receipt of the returned items, receiving personnel inspect the items and compare them to the RMA (R_REV_8). Receiving personnel enter goods receipts within SAP to record the quantity received for the sales return associated with the RMA (C_REV_6). If there are differences or

damaged returns, the RMA is forwarded to the Claims Group for review and approval. All RMAs are submitted to the Customer Service Manager for final review and approval of the return based on review against goods receipt information in SAP (R_REV_6) (R_REV_9). Upon approval of the RMA in the SAP system, a credit memo is generated systematically based on pricing information obtained from the original invoice that was recorded on the RMA (R_REV_7 | C_REV_7). Based on the credit memo that is issued, SAP automatically adjusts the general ledger to reverse the sales transaction; accounts receivable, sales, inventory, and cost of goods sold are reversed for the returned goods.

On a weekly basis, the Customer Service Director reviews the return details on the Goods Receipt information within SAP against the credit notes issued to determine that credits were issued in accordance with company policy. Any differences are resolved and corrective actions are taken (C_REV_5).

On a monthly basis, the Accounting Clerk evaluates the end-of-month position on returns through discussions with Customer Service Associates. If any significant pending returns are known but not recorded, a specific reserve is created to cover the anticipated exposure. The Accounting Clerk creates the journal entries in SAP to book the monthly return reserve; the Accounting Manager must post/approve the journal entry to record the reserve (R_REV_10 | C_REC_4).

On a monthly basis, the Accounting Manager obtains representations from the Customer Service Director who handles sales orders and credit notes. The representations are obtained to indicate that no verbal or unrecorded credit memos exist that have not been reported to finance management (R_REV_2, R_REV_7 | C_REC_3). After receiving the representations on unrecorded credit memos, the Accounting Clerk prepares a schedule of credit memos issued 3 days before and after the end of the month for analysis and review to make certain the sales and returns are recorded in the appropriate accounting period (R_REV_11). The Accounting Manager reviews and approves the schedule to ensure that sales returns are recorded in the correct period (C_REV_8) (C_REC_1). If any issues are noted regarding the cut-off or completeness of the sales returns, necessary adjustments are made by the Accounting department and support documentation is maintained.

The following is the IPE identified in the process flow:

- Non-standard Transaction Report (REV-IPE3)

IG 3 Difference between Process and Control (Refer Paragraph 100)

IG 3.1 Process and controls are two very different aspects. Often they are used interchangeably; hence it is important to understand the difference between them.

A **Process** describes the action of taking a transaction or an event through an established and usually a routine set of procedures or steps.

A **Control** is an action or activity taken to prevent or detect misstatements within the process.

The following examples distinguish a process from a control:

Example 1:

Control description: Company engages an Actuary Firm to prepare the actuarial report.

Pitfall: Hiring a specialist may add competency to management's control and is a process, but it is not a control in itself.

Improved control description: Management reviews and discusses the Actuarial Report, including key assumptions, with the specialist to assess the appropriateness of the assumptions and conclusions reached.

Example 2:

Control description: The Financial Controller prepares a memo documenting the basis for the entity's conclusions regarding impairment.

Pitfall: Preparing an analysis is typically a process step and not a control; the control is the activities performed to verify that the analysis is appropriate.

Improved control description: The CFO reviews the Impairment Analysis Memo and supporting documentation prepared by the Controller to assess the appropriateness of the conclusions reached.

Example 3:

Control description: The billed revenue file is summarised at the month end and the total is recorded into revenue.

Pitfall: Recording an event or transaction is a process step; the control is the activity that is performed to verify that the recording was appropriately performed.

Improved control description: The Accounting Manager verifies that the billed revenue was properly recorded to revenue by comparing the billed revenue file to the revenue recorded in the general ledger.

Example 4:

Control description: When new contracts are entered into or existing contracts are modified, the accounting manager determines and documents in a memo, the applicable revenue recognition model to be used for the contract.

Pitfall: Determining the revenue recognition model and documenting the same are process steps. They do not have any preventive or detective action steps.

Improved control description: The controller reviews and approves the revenue recognition memo prepared by the accounting manager. As part of the review process, the controller reads all the relevant excerpts from the contract and applicable professional standards as well as reviews and challenges, as appropriate, the conclusions documented in the memo.

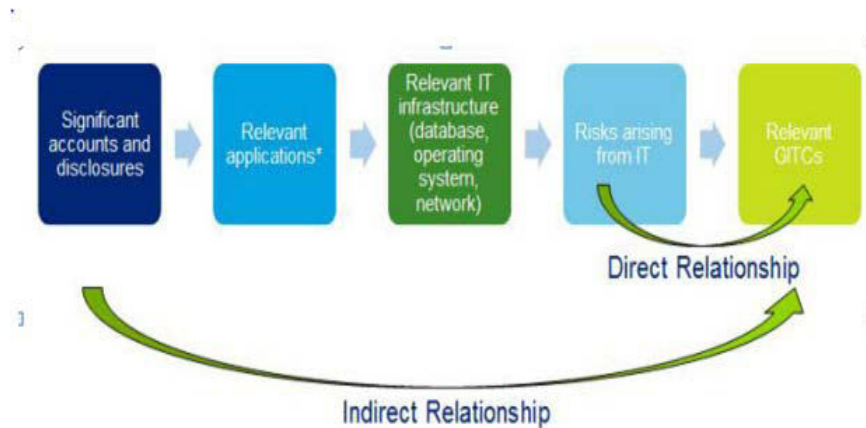
IG 4 Understanding IT Environment (Refer Paragraph 102)

IG 4.1 Based on the identification of the relevant flows of transactions or processes, the auditor also identifies the relevant IT environment related to those flows or processes to understand the

III.598 Auditing Pronouncements

effect of IT and the risks arising from IT. The term IT environment includes both the application systems and the IT infrastructure supporting those applications systems, including the database, operating system and network.

IG 4.2 The auditor identifies the relevant applications and IT infrastructure to identify the relevant risks arising from IT (IT risks) that need to be addressed for purposes of opining on internal financial controls and for purposes of being able to use a control reliance strategy for those accounts that are impacted by the IT risks (i.e., those accounts where the risks of material misstatement are addressed by controls that are dependent upon the relevant application systems and IT infrastructure.) He or she then identifies and tests the relevant general IT controls that address those IT risks. The relationship between risks of material misstatement, IT risks and relevant GITCs is depicted in figure below.



IG 4.3 The auditor's procedures related to IT risks and controls are performed in the context of the relevant flows of transactions related to significant accounts and disclosures. In other words, the auditor is not required to obtain an understanding of all the entity's IT systems; instead, he or she focuses on those aspects of the entity's IT environment that may pose risks to the entity's financial statements. Even when a control-reliance strategy is not planned, the auditor's understanding of IT's role in the entity's processes is important to the identification and assessment of risks of material misstatement and to plan further substantive procedures.

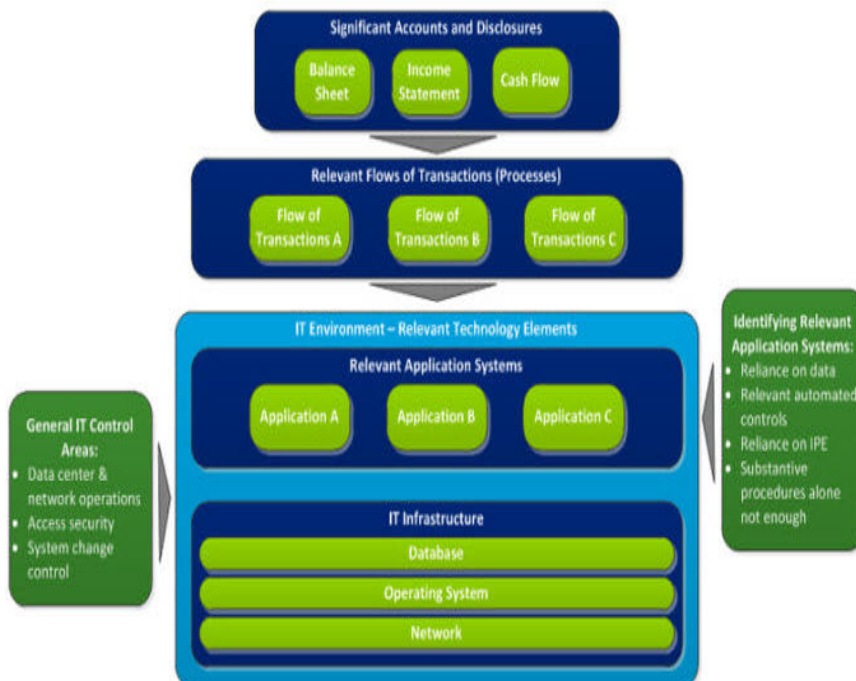
IG 4.4 The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures within both IT and manual systems by which those transactions are initiated, authorised, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
- The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorise, record, process, and report transactions. This includes the correction of incorrect information and how information

is transferred to the general ledger. The records may be in either manual or electronic form.

- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions, or adjustments.

IG 4.5 The diagram below depicts a typical IT environment, including the relationship between the significant accounts and disclosures, the related flow of transactions, the related application systems, the IT infrastructure supporting those applications, and the relevant GITCs, modified to align with the auditor's terminology. Notably, the diagram illustrates that the identification of the relevant aspects of the IT environment follows the auditor's identification of significant accounts and disclosures, further emphasising that the relevant aspects of the IT environment are identified based on the effect they may have on the entity's internal control, and ultimately on the financial statements.



IG 4.6 In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

III.600 Auditing Pronouncements

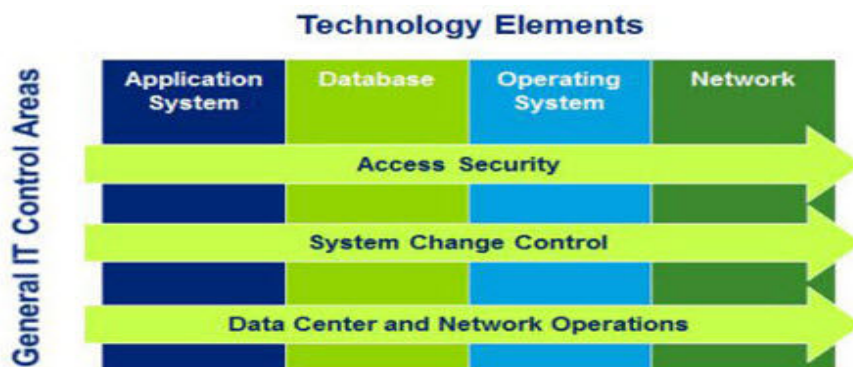
- *Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions or inaccurate recording of transactions. Particular risks may arise when multiple users access a common database.*
- *The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties.*
- *Unauthorised changes to data in master files.*
- *Unauthorised changes to systems or programs.*
- *Failure to make necessary changes to systems or programs.*
- *Inappropriate manual intervention.*
- *Potential loss of data or inability to access data as required.*

Understanding general information technology controls (GITCs)

IG 4.7 General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations.
- System software acquisition, change, and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

IG 4.8 GITCs include controls in the three areas of access security, system change control, and data centre and network operations. GITCs also include controls over each of the relevant technology elements within the entity's IT environment, including the application systems, databases, operating systems, and networks. As depicted in Figure below, GITCs are typically structured such that there are similar controls in place for each of the GITC areas across each of the technology elements.



Access security

IG 4.9 GITCs related to access security include logical access controls to prevent or detect unauthorised use of, and changes to, data, systems, or programs, including the establishment of system-based segregation of duties.

IG 4.10 An entity will typically have numerous controls in place to address logical access security, such as implementing user authentication to its systems through the use of unique user IDs and passwords; controlling the process for assigning, modifying, and terminating user access; monitoring the use of privileged-level access; and periodically reviewing user access privileges for appropriateness.

IG 4.11 Entities also control access to their systems through establishing segregation of duties controls. From an IT perspective, the auditor typically considers segregation of duties as it relates to each of the following types of users:

- End user system access — End users may be defined as entity personnel outside of the IT department who use the entity's application system (e.g., to process transactions or perform controls related to significant accounts and disclosures).

For example, a control over end-user access that prevents a single user from having access to both enter and approve journal entries may address risks of material misstatement related to the recording of fictitious or fraudulent journal entries for various significant accounts and disclosures.

- IT personnel system access — IT personnel may be defined as entity personnel responsible for administering the entity's IT systems (e.g., system administrators, security administrators). Segregation of duties controls over IT personnel system access are typically controls that address IT risks. It is typically appropriate for the auditor to test segregation of duties whenever testing user access to the entity's IT systems.

For example, a control over IT personnel system access that prevents a single IT system administrator from having access to both make changes to systems and promote those changes to the production environment may address an IT risk related to the promotion of unauthorised changes into the production environment, resulting in inappropriate modifications to systems or data.

System change control

IG 4.12 GITCs related to system change control include controls within the following categories:

- Program change: Controls to provide assurance that changes to the application systems and database management systems are implemented in a controlled manner.
- System software acquisition, change and maintenance: Controls to provide that network and communication software, systems software, and hardware are effectively acquired, changed, and maintained.
- Application system acquisition, development, and maintenance: Controls to provide that application systems and database management systems are effectively acquired,

developed, implemented, and maintained. System change controls address implementation and integration of programs or systems within the IT environment to verify the integrity of processing, performance, and controls over the computerised application systems that it supports.

Data centre and network operations

IG 4.13 GITCs related to data centre and network operations include controls to provide for the integrity of information as it is processed, stored, or communicated by the relevant aspects of the IT infrastructure.

IG 5 Entity-level Controls (ELCs) (Refer Paragraph 88-93)

IG 5.1 ELCs may be categorised into three “buckets”. These “buckets” align with the distinction of direct controls and indirect controls and are described as follows:

- Indirect entity-level controls — Those ELCs that do not themselves directly address risks of material misstatement at the account/assertion level but are important to effective internal control and therefore relevant in an audit of internal financial controls. These include controls that typically fall within the control environment, risk assessment, monitoring, and information and communication components of internal control system, including the general IT controls.
- Direct entity-level controls that are not precise enough — Those ELCs that directly address a risk of material misstatement but are not precise enough *on their own* to fully address a risk of material misstatement at the account/assertion level. While the auditor may identify these as relevant controls and test them, the auditor should also identify and test the effectiveness of other controls that in combination with the entity-level control address the risk of material misstatement.
- Direct entity-level controls that *are precise enough* — Those ELCs that directly address a risk of material misstatement at the account/assertion level and are precise enough on their own to fully address the risks of material misstatements.

IG 5.2 *Entity-level controls vary in nature and precision:*

- *Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.*
- *Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.*

- *Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.*

IG 5.3 An auditor makes inquiries and applies his or her knowledge of the business and organisational structure to understand and identify ELCs across all three “buckets,” as the nature and effectiveness of ELCs affects the audit plan in three important respects, as follows:

- In terms of their impact on the scope of testing in case of multi-location or multi-business entities.

For example, the effectiveness (or ineffectiveness) of the ELCs is a relevant factor for determining the audit plan for an entity as a whole for both the audit of the financial statements and the audit of internal financial controls.

- In terms of their impact on the scope of testing of other controls.

For example, the effectiveness (or ineffectiveness) of the ELCs is a relevant factor for assessing risk associated with the control and the auditor’s determination of the nature, timing and extent of testing of the operating effectiveness of such controls, including roll forward procedures to the balance-sheet date.

IG 5.4 The auditor must test those entity-level controls that are important to the auditor’s conclusion about whether the company has effective internal financial controls. The auditor’s evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

- In terms of whether the ELCs are sufficiently direct and precise to address one or more assessed risks of material misstatement.

Direct and precise entity-level controls (D&P ELCs)

IG 5.5 D&P ELCs are typically review-type (detective) controls that can exist at any level in an organisation (and often exist in multiple layers). To identify those D&P ELCs that may be relevant, the auditor should make inquiries, beginning at the top of the organisation (e.g., Corporate Financial Reporting Department), regarding how the entity determines that its financial statements are prepared in accordance with the applicable financial reporting framework and are free of material misstatement and then work down through the various layers in the organisation. In larger organisations, ELCs that operate at the segment/division or location level are generally more direct and precise than those that operate at the group level.

D&P ELCs at multiple levels within an entity often have different purposes or focus, and therefore may be relevant in addressing different risks of material misstatement.

For example, in an entity with more than 300 components, the balance sheet and income statement of each component are reviewed in detail at the segment level by segment controllers, while the monthly financial reporting package, which includes key performance indicators and trend lines, is analysed at the group level by a financial analysis team. Since the focus of the reviews is different, both ELCs may be relevant controls in the context of an audit.

III.604 Auditing Pronouncements

IG 5.6 The form of an ELC may be very narrow in scope such as the review of a specific analysis related to a specific account/assertion (e.g., an analysis supporting a material accounting estimate) or may be broad in scope such as the review of a financial reporting package that may depict actual trends lines, actual to budget/forecast, and key performance measures for the balance sheet and income statement (including analyses of certain accounts and commentary about unusual transactions or variances).

When a review is broader in scope, it may not be precise enough to address all the risks of material misstatement related to the accounts subject to the review but may be precise enough to address the risks of material misstatement related to some accounts.

For example, a direct and precise ELC that consists of a monthly review of the monthly financial reporting package may be sufficiently precise for some of the accounts where more detailed analyses are performed but may not be precise enough for others where the review activities are more high-level.

IG 5.7 Examples of “direct but not precise enough” ELCs may include:

- Variance analysis of actual to budget, where budget is a “target” established at the beginning of the year but not a valid expectation against which to measure actual results in order to conclude positively that there is no material misstatements in the actual balance or amounts recorded. Budget versus actual analyses are often intended to be used for the primary purpose of explaining variances from budget for operational purposes, not to detect misstatements; therefore, these analyses are generally not effective in detecting misstatements when actual approximates budget. For a budget versus actual analysis to be an effective D&P ELC, the budget needs to represent a sufficiently precise expectation of the actual balance or amount.
- Trend-line analyses (e.g., current-year to prior-year comparisons) of an account balance, as this kind of analysis typically would not identify misstatements if there were no significant fluctuations between amounts recorded in the current and prior year.

IG 5.8 Examples of direct and precise ELCs may include:

- A variance analysis of rent expense to budget where budget is a valid expectation (e.g., based on the actual lease provisions) that is not expected to materially change during the applicable reporting period.
- Detailed analysis of prepaid expenses such that the reviewer, with sufficient knowledge of the accounts and related transactions and therefore a basis for an independent expectation, would reasonably be expected to identify a material misstatement in the recorded amount.

IG 6 Segregation of Duties (Refer Paragraph 113)

IG 6.1 Segregation of duties means assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person’s duties.

IG 6.2 *Business case of implementing segregation of duties:*

- *Mitigating fraud risks.*
- *Compliance with regulatory requirements.*
- *Implementation of meaningful control strategies.*
- *Pivotal for adequate access controls in an ERP scenario.*
- *Integral in case of outsourced operations.*

IG 6.3 *The following are the typical set of tasks / activities that need to be segregated from a generic perspective:*

- *Initiating a transaction (including developing appropriate documentation).*
- *Authorising the transaction.*
- *Recording the transaction.*
- *Monitoring custody of the physical asset.*
- *Reconciling subsidiary ledgers with the general ledger.*
- *Processing master file transactions.*
- *Authorising master file transactions.*
- *Following up on issues or discrepancies.*
- *Controlling systems development and daily operations in computer-based accounting systems.*

IG 7 Automated Controls (Refer Paragraph 113)

Application controls defined

IG 7.1 Application controls are a subset of internal controls that relate to an application system and the information managed by that application. Timely, accurate and reliable information is critical to enable informed decision making. The timeliness, accuracy and reliability of the information are dependent on the underlying application systems that are used to generate, process, store and report the information. Application controls are those controls that achieve the business objectives of timely, accurate and reliable information. They consist of the manual and automated activities that ensure that information conforms to certain criteria that is referred to as business requirements for information. Those criteria are effectiveness, efficiency, confidentiality, integrity, availability, compliance and reliability.

Automated control in a way is technology used to automate control activities

IG 7.2 Many control activities in an entity are partially or wholly automated using technology. These procedures are also known as automated control activities or automated controls. Automated controls include financial process-related automated transaction controls, such as a three-way match performed within an ERP system supporting the procurement and payables sub-processes, and computerised controls in operational or compliance processes, such as checking the proper functioning of a power plant. Sometimes the control activity is purely automated, such as when a system detects an error in the transmission of data, rejects the transmission, and

III.606 Auditing Pronouncements

automatically requests a new transmission. Other times there is a combination of automated and manual procedures. For example, the system automatically detects the error in transmission, but someone has to manually initiate the re-transmission. In other cases, a manual control depends on information from a system, such as computer-generated reports supporting a budget-to-actual analysis.

IG 7.3 Most business processes have a mix of manual and automated controls, depending on the availability of technology in the entity. Automated controls tend to be more reliable, subject to whether technology general controls, discussed later in this Section, are implemented and operating, since they are less susceptible to human judgement and error, and are typically more efficient.

Assurance on automated controls

IG 7.4 Application controls relate to the transactions and master file, or standing data pertaining to each automated application system, and are specific to each application. They ensure the accuracy, integrity, reliability and confidentiality of the information and the validity of the entries made in the transactions and standing data resulting from both manual and automated processing.

IG 7.5 The objectives relevant for application controls generally involve ensuring that:

- Data prepared for entry are authorised, complete, valid and reliable.
- Data are converted to an automated form and entered into the application accurately, completely and on time.
- Data are processed by the application accurately, completely and on time, and in accordance with established requirements.
- Data are protected throughout processing to maintain integrity and validity.
- Output is protected from unauthorised modification or damage and distributed in accordance with prescribed policies.

Benchmarking of automated controls

IG 7.6 *Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.*

IG 7.7 *If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.*

IG 7.8 *The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.*

IG 7.9 To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- *The extent to which the application control can be matched to a defined program within an application.*
- *The extent to which the application is stable (i.e., there are few changes from period to period).*
- *The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)*

IG 7.10 Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

IG 7.11 After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be re-established.

IG 7.12 To determine when to re-establish a baseline, the auditor should evaluate the following factors –

- *The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.*
- *The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.*
- *The nature and timing of other related tests.*
- *The consequences of errors associated with the application control that was benchmarked.*
- *Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.*

IG 8 Information Produced by the Entity (Refer Paragraph 113)

IG 8.1 The auditing standards do not provide a definition of information produced by the entity (IPE) or describe what constitutes IPE. IPE is typically in the form of a "report" which may be either system-generated, manually-prepared, or a combination of both (e.g., a download of system accumulated data that is then manipulated in an Excel spreadsheet). Examples of different forms of reports include:

- *Standard "out of the box" or default reports or templates that either:*

III.608 Auditing Pronouncements

- May not be modified and therefore don't allow for customisation of inputs/outputs (e.g., a system generated standard Debtors aging report with no configurable settings or user optionality, that in today's IT environment of ERP systems is fairly rare), or
- May be configurable upon installation (e.g., by adding custom fields to a report design or removing fields on a report that are not required to be displayed) and can be modified thereafter through established program change processes (e.g., a system generated standard Debtors aging report with configurable settings such as user defined aging categories and user options for specifying the logic, such as the manner in which the aging is computed, that is more typical in today's IT environments).
- Custom-developed reports that are not standard to the application and that are defined and generated by user-operated tools such as scripts, report writers, programming language and query tools (e.g., a monthly user-initiated extract of inventory sales by SKU).
- Output from end-user applications such as automated spreadsheets or other similar applications that house and extract relevant information (i.e., data).
- Entity-prepared analyses, schedules and spreadsheets that are manually prepared by entity personnel either from information generated from the entity's system or from other internal or external sources.

IG 8.2 As there may be a large amount of information that is generated by an entity for use in managing the business and to analyse and prepare financial information, the auditor is only required to test the accuracy and completeness of IPE that is relevant to the audit and used as audit evidence, not all information that is produced by the entity.

IG 8.3 IPE that is relevant to the audit and used as audit evidence generally falls into one of three "buckets" as depicted in below:

IPE that the entity uses	When performing relevant controls
IPE that the auditor uses as an audit evidence	When performing tests of operative effectiveness of relevant controls
IPE that the auditor uses as an audit evidence	When performing substantive procedures

Understanding IPEs

IG 8.4 In order to design appropriate procedures to test the accuracy and completeness of IPE, it is important to first obtain an appropriately detailed understanding of the IPE. The auditor begins with a thorough understanding of what the IPE is, how the IPE is generated, and how the auditor intends to use it as audit evidence. This allows the auditor to design the most appropriate testing approach to determine whether the IPE is sufficient and appropriate for purposes of the audit.

IG 8.5 IPE typically consists of three elements: (1) source data, (2) report logic, and (3) parameters.

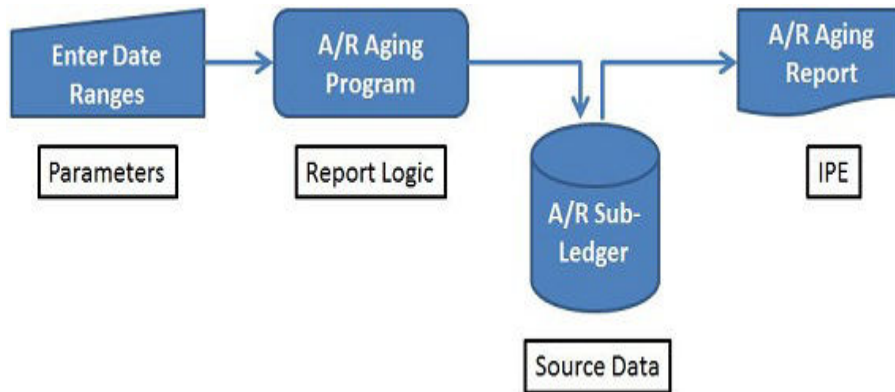
Accordingly, it is important that the auditor obtains an understanding of each of these three elements to determine the testing strategy for IPE. These three elements are further described as follows:

Element	Description
Source Data	<p>The information from which the IPE is created. This may include data maintained in the IT system (e.g., within an application system or database) or external to the system (e.g., data maintained in an Excel spreadsheet or manually maintained), which may or may not be subject to general IT controls.</p> <p>For example, for a report of all sales greater than Rs. 1,000,000, the source data is the database of all sales transactions.</p>
Report Logic	<p>The computer code, algorithms, or formulas for transforming, extracting or loading the relevant source data and creating the report. Report logic may include standardised report programs, user-operated tools (e.g., query tools and report writers) or Excel spreadsheets, which may or may not be subject to the general IT controls.</p> <p>For example, for the Debtors Aging report, the report logic is typically a program in the Debtors application that contains the code and algorithms for creating the Debtors Aging (report) from the Debtors sub-ledger detail (source data).</p>
Report Parameters	<p>Report parameters allow the user to look at only the information that is of interest to them. Common uses of report parameters including defining the report structure, specifying or filtering data used in a report or connecting related reports (data or output) together. Depending on the report structure, report parameters may be created manually by the user (user-entered parameters) or they may be pre-set (there is significant flexibility in the configuration of parameters, depending on the application system), and they may or may not be subject to the general IT controls.</p> <p>For example, for a monthly report of slow moving inventory by warehouse location, the user enters the month and location code parameters to generate the reports.</p>

IG 8.6 Figure below portrays the process and the three elements of IPE to generate a typical Debtors aging report: (1) the user-entered parameters (i.e., date ranges), (2) the source data (i.e., the Debtors sub-ledger), and (3) the report logic that generates the Debtors aging report (which includes both the extraction of the source data from the Debtors sub-ledger and the aging of the items).

Figure

III.610 Auditing Pronouncements



IG 8.7 The auditor's objective when performing procedures on IPE is to determine if these three elements, when applicable, produce IPE that is accurate and complete. As IPE is generated in many different forms and through many different methods, the testing strategy may vary depending on the intended purpose of the IPE, the nature of the IPE (e.g., a standard pre-coded report versus a custom ad-hoc report) and how it is created (e.g., the degree of automation which typically increases reliability when subject to effective general IT controls).

For example, Entity A and Entity B both use the same ERP system; however, Entity A uses an Debtors aging report from the system to determine its allowance for doubtful accounts, and Entity B takes the same Debtors aging report, downloads it into Excel, and then manually manipulates the report. The downloading and manipulation of Entity B's report likely introduces additional possibilities that the IPE may be inaccurate or incomplete compared to the Debtors aging report used by Entity A and therefore, it would likely be necessary to perform additional procedures on Entity B's report to determine its accuracy and completeness as compared to Entity A's report.

IG 8.8 The following considerations related to accuracy and completeness of IPE may assist the auditor in obtaining an appropriate understanding to plan the testing approach to IPE:

- Not all data is captured.
 - For example, if all revenue transactions are not captured in the system, a report of revenue data that is derived from the system would likely be incomplete.
- The data is input incorrectly.
 - For example, data entry errors (e.g., a number that is transposed or entered incorrectly) into an Excel spreadsheet may result in incorrect totals in the spreadsheet.
 - For example, SAP maintains a central exchange rate table which is used to translate foreign currency transactions into the local reporting currency. The table is manually updated and therefore subject to human error (e.g., incorrect exchange rates may be input). Therefore, the system-generated report identifying the exchange rates may be incorrect.
- The report logic is incorrect.

- For example, a report is designed to include sales transactions for which the variation between the actual selling price of an item and the price of that same item in the entity's standard price list is in excess of 15 percent; however, the report was incorrectly configured to only include transactions for which the variance is in excess of 20 percent.
- For example, the system performs a consolidation of the various reporting entities based on company codes. If a new entity is not initially coded correctly, the manner in which it is consolidated into the overall results of all the reporting entities may not be correct.
- For example, the entity relies on a report of average selling prices to monitor compliance with its pricing policies; however, the algorithm that calculates the average selling prices was inadvertently applied to sales occurring at only certain business units (i.e., the calculation was not applied to the entire population).
- The report logic or source data could be changed inappropriately or without authorisation.
 - For example, IT management runs a report of all changes to the entity's ERP application as part of a control to determine whether all changes were properly tested and approved prior to implementation. In order to conceal an error that he had made, an employee in the IT department, who had administrator access to the system, manipulated the report to exclude an unauthorised change he made.
 - For example, the report is an Excel spreadsheet that is not subject to general IT controls or otherwise protected and, therefore, may be subject to unauthorised changes.
- The user-entered parameters entered are incorrect.
 - For example, user-entered parameters related to the date range are required when generating a Debtors aging report. If the user-entered parameters are not entered correctly, the data on the report will not likely be correct (e.g., the report may not contain the expected or intended data).
 - For example, consider the circumstance in which a query tool is utilised by a user to extract receivables account detail related only to a particular customer. If the user-entered parameters are not set up to specifically and properly extract all the detail for the specified customer and only the specified customer, then the IPE may not be accurate and complete.

Evaluating IPE

IG 8.9 The auditor is required to "evaluate whether the IPE is sufficiently precise and detailed for purposes of the audit." This involves evaluating whether the IPE is appropriate for its intended purpose (e.g., the objectives of the specific control or substantive procedures for which it is being used).

IG 8.10 If the IPE is not sufficiently precise or detailed for the purpose, it is likely that the auditor cannot use it as audit evidence; however, the auditor may work with the entity to determine if the original IPE can be modified by the entity to meet his or her needs or identify other audit evidence

III.612 Auditing Pronouncements

to achieve the intended purpose. Typically, the auditor evaluates whether IPE is sufficiently precise and detailed for the stated purposes based on his or her understanding of IPE and the results of the procedures the auditor performs to address accuracy and completeness of the IPE.

For example, when the auditor is testing program change controls and the client provides a listing of application system changes in a Word document that does not provide sufficient information to identify the related changes made in the source code library for the application system (i.e., the listing is not sufficiently precise), the auditor may require management to either modify the report or to identify an alternative source or form of the information (e.g., a program change listing from the source code library management tool) that will be sufficiently precise and detailed for testing purposes.

IPE in the context of internal financial controls testing

IG 8.11 IPE in the context of internal control testing is IPE that the auditor uses as audit evidence to perform his or her tests of controls and, therefore, the auditor needs to perform procedures to determine that the IPE is accurate and complete.

For example, when testing the effectiveness of an entity's program change controls, the auditor may request the entity to provide a system-generated report that identifies the modifications made to a specific application during a specified time period and use such a report to identify and select items for testing of the entity's program change controls. The testing of change controls relies on the report being accurate and complete; therefore, the auditor needs to perform procedures to address the accuracy and completeness of the report.

IG 8.12 When the auditor uses a report (IPE) to identify the population of items of interest from which to draw the sample for testing, the tests of the items selected from the report typically address the accuracy of the report; however, such procedures often do not address the completeness of the report.

For example, when testing the effectiveness of an entity's program change controls, the auditor obtains a report listing the changes logged during the period of audit interest. When the auditor makes selections from that report and tests them to determine if the entity's controls over program changes are effective, the auditor is also obtaining evidence of the accuracy of the report. The auditor should design and perform other procedures to address the completeness of the report (e.g., the auditor may select program changes that the auditor identified from an independent population and trace them to the report of program changes or the auditor could test the effectiveness of the controls over the completeness of the report of program changes).

IG 8.13 The auditor may test IPE that he proposes to use to perform tests of controls by either:

- Performing "direct testing" procedures to address the accuracy and completeness of IPE. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor may directly test IPE that the auditor uses to perform tests of controls only when management is not using the IPE in the performance of its controls.
- Perform procedures to test controls that address the accuracy and completeness of the IPE.

- A combination of these approaches (i.e., performing direct testing and tests of controls to address the accuracy and completeness of IPE).

Testing accuracy and completeness of IPE that the entity's controls are dependent upon

IG 8.14 The auditor obtains evidence that such IPE is sufficiently reliable throughout the period of intended reliance. For a combined audit of internal financial controls over financial reporting and financial statements, the auditor is required to identify and test the effectiveness of controls addressing the accuracy and completeness of the information the controls are dependent upon.

IPE that the auditor uses in tests of operating effectiveness of relevant controls

IG 8.15 The auditor may obtain information to use in performing tests of certain controls, such as reports on system settings (e.g., access, profiles, passwords) or reports used to define the population of interest (e.g., a list of program changes). The auditor also performs procedures to test the accuracy and completeness of such IPE since the integrity of the tests of operating effectiveness of the relevant controls depends on the accuracy and completeness of that information.

Direct testing of IPE

IG 8.16 The appropriate procedures and sample size for directly testing IPE is a matter of professional judgement based on the nature of the IPE and may vary depending upon the specific facts and circumstances.

IG 8.17 In order to determine whether "directly" testing IPE is the most effective and efficient testing method, the auditor considers whether and to what extent his tests of controls or substantive procedures address the accuracy or completeness of the IPE. For example:

1. Consider if the IPE is the starting point of the substantive procedures, and therefore, whether the substantive procedures for testing the relevant assertions for the class of transactions, account balance, or disclosure also address the accuracy and completeness of the three elements of the IPE. In such cases, additional procedures may not be necessary.

For example, the auditor may use a property roll forward schedule prepared by the entity as the starting point to perform the substantive testing of the property account balance. The substantive procedures of the property account balance (either tests of details or substantive analytical procedures) would likely include procedures that would address the accuracy and completeness of the information on the roll forward schedule, such as agreeing totals from the schedule to the beginning and ending general ledger balances, footing the schedule, and making selections from the various totals reflected on the schedule (e.g., additions, disposals, depreciation) to test by agreeing back to source documents or by recalculation. In this case, additional procedures to address the completeness and accuracy of the elements of the IPE are not likely necessary.

2. Consider if the IPE is extracted from data related to classes of transactions, account balances, or disclosures that is already being tested as part of the audit — either by testing the relevant controls or through substantive procedures. If so, the auditor may need to only plan

III.614 Auditing Pronouncements

additional testing of the remaining IPE elements (i.e., the report logic and, if applicable, the user-entered parameters).

For example, the auditor tests the relevant controls over sales, billing, and cash receipts, including the relevant general IT controls, for control reliance purposes and substantive procedures validate that the transaction data in the Debtors sub-ledger is accurate and complete and protected from unauthorised access or changes. Accordingly, when testing the Debtors aging report which is derived from the Debtors sub-ledger detail, the auditor does not need to trace selections back to source documents as the auditor has already determined through tests of relevant controls that the Debtors sub-ledger detail is accurate and complete.

IG 8.18 However, even when the auditor may have tested the controls related to the underlying source data or substantively tested the source data; he may still need to perform procedures to address the appropriateness of the report logic and user-entered parameters used in producing the IPE. In some cases, the auditor may be able to use the same items tested (or a subset thereof) for control tests or substantive procedures to perform procedures specifically directed at the accuracy and completeness of the process to extract the relevant data into the report.

For example, although the auditor has already determined through tests of relevant controls that the Debtors sub-ledger detail is complete and accurate, he still needs to perform procedures to address the appropriateness of the report logic. Therefore, to validate that the data in the Debtors aging report was properly extracted, the auditor may reconcile the Debtors aging report to the Debtors sub-ledger in the aggregate and then trace into the Debtors aging report the relevant information for the items (or subset thereof) that were selected for Debtors confirmations.

IG 8.19 Consider if the IPE consists of source data that may be tested for accuracy and completeness in conjunction with other tests of controls or substantive procedures for the relevant flows of transactions.

For example, when performing substantive test of sales transactions the auditor may also include testing that the product codes/SKUs were properly coded and input into the system in order to validate that the data at the sales by product code/SKU level is accurate and complete.

For example, when performing tests of controls, the auditor may also assess whether the identified controls specifically address the recording and reporting of revenue and expenses by location.

Example of IPE testing

Data/ Report Description	Terminated Employee Listing
Background	The Terminated Employee Listing is a standard parameter-driven report generated directly from the HR application and provided to auditors. The report pulls the names of employees terminated during a particular date range (i.e., the period under audit), as well as other pertinent information about the employees, such as their employee IDs and the effective dates of their separations from the entity. This report will be used by the auditor to determine

	<p>whether there are active user accounts in the system for any of the terminated employees in order to test GITCs related to timely deactivation and/or removal of user accounts when employees terminate employment with the entity.</p>
Example Testing Approach 1	<p>The auditor compares the Terminated Employee Listing on a sample basis to relevant information in the system, and vice versa, to determine that:</p> <ol style="list-style-type: none"> 1. The report was created from the appropriate production system during the period under audit. 2. The appropriate user-entered parameters were used to generate the report (e.g., date range). 3. The employee information in the system is consistent with that in the report. <p>Additional audit evidence is obtained that the report accurately includes a complete population of terminations that occurred during the period under audit:</p> <ul style="list-style-type: none"> • For example, inquiry is made of entity personnel to obtain the names of X individuals who were terminated in the period under audit and the timeframe during which these individuals were terminated (e.g., if the auditor knows the entity did layoffs at a certain time during the year). The Terminated Employee Listing is inspected to determine that the individuals identified during the auditor's inquiries appear on the list and the termination dates on the listing are consistent with those communicated to the auditor during his or her inquiries. • For example, a selection is made of terminated employees from the source where termination status is maintained and it is validated that the terminated employees appear on the Terminated Employee Listing.
Example Testing Approach 2	<p>The auditor should test the relevant controls that provide audit evidence of the timely and accurate processing of terminations in the HR application, including the employment status of employees (e.g., active, terminated) and termination dates.</p> <p>As the report logic had been tested in the prior year, the auditor may apply a benchmarking strategy (e.g., carry forward a summary of direct testing of the report logic and user-entered parameters performed upon initial installation of the system, including describing the Terminated Employee Listing, how it was tested, and the conclusions reached. The auditor should also obtain evidence in the change management system that validates that the source code underlying the report has not been changed since it was originally tested in the prior year</p>

IG 9 Use of Service Organisations (Refer Paragraph 90)

Service organisations

IG 9.1 The auditor's understanding of the flows of transactions includes an understanding of the entity's use of service organisations to perform processes relevant to financial reporting (e.g., payroll processing, processing of insurance or medical claims) and, from an IT perspective, the systems that are being used by the service organisations to perform those processes. In addition to outsourcing certain business processes to a service organisation, an entity may also outsource administration of one or more of its systems to a service organisation or use a service organisation to "host" its systems.

Identifying relevant service organisations

IG 9.2 Regardless of whether a service organisation is being used to perform business processes or IT functions, to the extent that these processes are relevant to the audit, the systems used by or administered by the service organisation (and the related general IT controls) may also be relevant to the audit. In determining whether these systems are relevant, the auditor considers the controls the user entity (i.e., an entity that uses a service organisation) and the service organisation have in place to address the related risks of material misstatement or IT risks. These may include controls at the service organisation when the service organisation is performing processes relevant to financial reporting or when a service organisation is hosting systems for the user entity. However, to the extent that the entity has controls in place that are sufficiently precise to address the relevant risks and these controls do not rely on automated controls, data, or reports from the systems used by or administered by the service organisation, the auditor may determine that the service organisation controls are not relevant to the audit.

For example, an entity outsources the processing of its payroll transactions to a service organisation; however, the entity has the following controls in place that are sufficiently precise to address the relevant risks of material misstatement related to payroll and the entity does not rely on reports or other information it receives from the service organisation to perform these controls:

- Comparing the payroll data submitted to the service organisation with reports of information received from the service organisation after the data has been processed.
- Re-computing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.

Situation in which service organisations are relevant for internal financial controls

IG 9.3 If the service organisation's services are part of a company's information system, then they are part of the information and communication component of the company's internal financial controls. When the service organisation's services are part of the company's internal financial controls, the auditor should include the activities of the service organisation when determining the evidence required to support his or her opinion.

IG 9.4 The following are the procedures that the auditor should perform with respect to the activities performed by the service organisation –

- *Obtaining an understanding of the controls at the service organisation that are relevant to the entity's internal control and the controls at the user organisation over the activities of the service organisation, and*
- *Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.*

IG 9.5 Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following:

- *Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed upon procedures that describes relevant tests of controls.*

Note: *The service auditor's report referred to above means a report with the service auditor's opinion on the service organisation's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period. A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.*

- *Performing tests of the user organisation's controls over the activities of the service organisation (e.g., testing the user organisation's independent re-performance of selected items processed by the service organisation or testing the user organisation's reconciliation of output reports with source documents).*
- *Performing tests of controls at the service organisation.*

IG 9.6 If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- *The time period covered by the tests of controls and its relation to the as of date of management's assessment,*
- *The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and*
- *The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.*

Note: *If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organisation, the auditor should evaluate whether the company is applying the necessary procedures.*

III.618 Auditing Pronouncements

IG 9.7 In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence.

IG 9.8 When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organisation's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organisation, changes in personnel at the service organisation with whom management interacts, changes in reports or other data received from the service organisation, changes in contracts or service level agreements with the service organisation, or errors identified in the service organisation's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal financial controls. The auditor should also evaluate whether the results of other procedures performed indicate that there have been changes in the controls at the service organisation.

IG 9.9 The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organisation based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- *The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,*
- *The significance of the activities of the service organisation,*
- *Whether there are errors that have been identified in the service organisation's processing, and*
- *The nature and significance of any changes in the service organisation's controls identified by management or the auditor.*

IG 9.10 If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organisation is required, the auditor's additional procedures might include –

- *Evaluating procedures performed by management and the results of those procedures.*
- *Contacting the service organisation, through the user organisation, to obtain specific information.*
- *Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.*
- *Visiting the service organisation and performing such procedures.*

IG 9.11 The auditor should not refer to the service auditor's report when expressing an opinion on internal financial controls.

IG 10 Techniques of Control Testing (Refer Paragraph 116)

IG 10.1 Tests of controls are usually performed using the following techniques, often in combination:

Corroborative enquiry: This procedure, consisting of detailed interviews to obtain evidence about the effectiveness of controls, is performed in tandem with other procedures (e.g., examination of documentary evidence) to corroborate the information derived from the inquiry.

Observation: Observing the performance of a control activity often provides substantial evidence of its effectiveness. For example, the auditor may test controls over inventory by observing that employees who perform and record the counts follow management's written instructions. But observation of a control activity in action ordinarily does not, in itself, provide sufficient evidence of the effectiveness of the control activity, mainly because observations may not be representative of the usual performance of a control activity because management and staff may perform their tasks more diligently if they know they are being observed.

Examination of Documentation: If performance of a control activity is documented, the auditor can obtain evidence of its performance by examining the documentation, both electronic and written.

Re-performance: Re-performance may be effective for testing application controls, because the computer processes transactions systematically.

IG 11 Internal Financial Controls – Testing of Design (Refer Paragraph 108 -109)

IG 11.1 The objective of testing the design of a control is to determine if a deficiency in design exists. A deficiency in design exists when:

- A control necessary to meet the control objective (i.e., a control that mitigates the risk of material misstatement) is missing.
- An existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met (i.e., the risk of material misstatement would not be mitigated).

IG 11.2 Therefore, it is important to consider and to specifically conclude with respect to both aspects based on the auditor's procedures and evaluation. Professional judgement is necessary to evaluate the design of relevant controls

IG 11.3 The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organisation. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and

III.620 Auditing Pronouncements

leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

IG 11.4 To appropriately evaluate the design of relevant controls, the auditor considers the following elements:

- The nature and significance of the risks of material misstatement addressed by the control.
- The characteristics or details of the control.
- Factors to determine whether the control is appropriately designed (i.e., the precision of a control) to address the identified risk.

Factors to consider when determining whether control is appropriately designed

The following factors will likely be a good starting point for evaluating the effectiveness of the design of many controls. (Note: these are not intended to be a complete list of considerations, nor is it intended that each of these is always relevant or needs to be considered for each control.)

IG 11.5 Appropriateness of the purpose of the control and its correlation to the risk/assertion

A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences. Additionally, a control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion. A control that identifies and explains differences may identify an unusual fluctuation but would not identify misstatements if there were no fluctuations.

For example, the purpose of a budget to actual revenue review is to typically identify and explain variances for operating purposes, not necessarily for the purpose of identifying misstatements.

It is important that this assessment be applied for each risk/assertion that a control addresses.

For example, if a control addresses six risks of material misstatement, then the purpose of the control and correlation to the risk/assertion is considered separately for each risk of material misstatement.

IG 11.6 Appropriateness of the control considering the nature and significance of the risk

The greater the inherent risk, the more precise the controls are expected to be.

For example, a higher-level D&P ELC may be appropriately precise for payroll expense, which is typically a normal risk of misstatement, but would likely not be sufficient by itself for a significant risk of material misstatement, such as a significant accounting estimate.

IG 11.7 Competence and authority of the person(s) performing the control

The experience level of the person performing the control and their organisational position affects the effectiveness of a control.

For example, if the assistant controller performs a review of a document prepared by the controller, the assistant controller's authority in performing such a review might be questioned, given the direct reporting relationship of the assistant controller to the controller.

For example, a junior clerk may not have the requisite knowledge of the business or stature within the organisation to perform an effective review control that requires an in-depth understanding of the business and the ability to raise challenges with superiors and others within the organisation.

For example, SAP security is administered by a Senior Analyst. The Senior Analyst is a Certified Information Systems Security Professional (CISSP), has ten years of IT experience and has been in his current position for two years. The auditor interacted with the Senior Analyst as he or she executed audit tests and found him to be knowledgeable of SAP security and controls. Based on these factors, it appears he has the competence and authority to operate SAP security controls.

For example, a control related to the review of user access privileges in a relevant application system is performed by a Manager, in the Information Compliance and Risk Management department of the entity. The auditor interacted with the Manager throughout the audit and noted she demonstrated sufficient knowledge of control processes related to the application system. The Manager has been responsible for overseeing the review of access and monitoring of the relevant application for the past three years. The auditor noted she appears to be competent to perform the controls for the relevant application system and has proper authority based upon her role, which was also confirmed by the auditor by reviewing an organisational chart.

Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

IG 11.8 Frequency and consistency with which the control is performed

A control that is performed routinely and consistently is generally more precise than one performed sporadically.

For example, a review control that has clearly defined procedures and which is designed to be performed each quarter would be more precise than a review control that has undefined process steps and which is performed infrequently or on an ad-hoc basis. Similarly, when general IT controls are effective, an automated control is expected to operate more consistently than a manual control.

IG 11.9 Level of aggregation and predictability

A control that is performed at a more detailed level generally is more precise than one performed at a higher level. The precision of those controls also depends on the predictability (i.e., the more predictable the expected result, the greater the precision to identify potential material misstatements).

For example, an analysis of revenue by location or product line is likely to be more precise than an analysis of total entity revenue.

IG 11.10 Criteria for investigation and process for follow-up

For review-type controls (unless the review is performed with regard to each transaction), the threshold for investigating deviations or differences and its relationship to materiality is an important but subjective determination of a control's precision. It is equally important that there is an appropriate process to follow-up on any exceptions or unusual items noted from the review, including tracking open items for timely resolution and determining that responses are appropriate and supported as necessary.

For example, a control that investigates items that are near the selected materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control that investigates items that are smaller relative to materiality.

Review-type controls require the reviewer to make significant judgements when determining what requires further investigation. Accordingly, when evaluating the design of a review-type control the auditor considers the risk of implicit or explicit bias in the reviewer's judgements in identifying a deviation or difference for investigation and follow-up. The auditor may also need to consider whether there are other controls that operate in conjunction with the review-type control that specifically address or mitigate the potential for bias (e.g., further review and challenge by others).

IG 11.11 Dependency on other controls or information

If the control is dependent upon other controls (e.g., the effective operation of general IT controls) or IPE, the design of the control cannot be concluded upon without also considering the effectiveness of the other control(s) or the accuracy and completeness of the IPE. When evaluating the design of a control that is dependent on IPE, the auditor should identify and test the effectiveness of relevant controls that address the accuracy and completeness of the IPE that the controls is dependent upon.

Testing design effectiveness

IG 11.12 The purpose of a test of design of a relevant control is to obtain a sufficient understanding of each control (and the related risk that the control addresses) to:

- Conclude on the effectiveness of its design to address the risk.
- Plan the nature, timing, and extent of the tests of operating effectiveness of the control.

A "test of design" of a relevant control includes inquiry of personnel involved in the performance of the control, supplemented by a mix of observation of how the control is performed (e.g., demonstration by entity personnel to the auditor what they do) and inspection of the relevant documentation related to the performance of the control (which may include either IPE used in the performance of the control or documentation resulting from the performance of the control). The test of design of a relevant control confirms the auditor's understanding of the controls (e.g., the detailed control description) and provides the basis to evaluate whether the controls are designed effectively (i.e., the auditor determines whether each risk is appropriately mitigated by the controls as designed).

IG 12 Internal Financial Controls–Walk Through(Refer Paragraph 103, 104, 108, 109)

Performing walkthroughs

IG 12.1 Walkthroughs are not required by the auditing standards; however, they are often an efficient means to:

- Obtain or update understanding of the entity's flow of transactions.
- Identify controls that are relevant to the audit and gain an understanding (evaluate design and implementation) of those controls.

IG 12.2 In some instances, when the auditor is testing controls, the walkthrough procedures may be used to obtain evidence about the operating effectiveness of a control.

IG 12.3 The term "walkthrough," while not specifically defined, refers to (1) the following of a transaction through the entity's process and (2) the procedures the auditor might perform to validate the points in the process at which a material misstatement could occur and identify controls that may be relevant to the audit.

IG 12.4 In performing a walkthrough, the auditor generally follows a single transaction from its origination through the procedures or steps in the process to the transaction's ultimate recording in the general ledger. Following the transaction through the procedures or steps in the process helps validate the auditor's understanding of how transactions are initiated, authorised, recorded, processed, and recorded. The procedures or steps addressed in the walkthrough would correspond to those in the process narratives or the narratives combined with process flow diagrams.

IG 12.5 It is important to differentiate between a step in the process and a control. A process describes the action of taking a transaction or event through an established and usually routine set of procedures or steps. A control is an action or activity taken to prevent or detect misstatements within the process. The following is the description and examples of control activities:

IG 12.6 Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

- Authorisation;
- Performance reviews;
- Information processing;
- Physical controls;
- Segregation of duties.

IG 12.7 To perform a walkthrough, the auditor would generally:

- Select a single transaction and trace it through the procedures or steps in the process, and the relevant control activities, from initiation to recording in the general ledger. The

III.624 Auditing Pronouncements

walkthrough would generally begin with the original source document for a selected transaction (e.g., a revenue walkthrough might begin with a sales order, rather than the sales invoice).

- Make inquiries of the individuals who perform the procedures or steps in the process.

IG 12.8 As a result, for the relevant controls within the process, the auditor would corroborate his or her inquiries of individuals who perform the controls with additional procedures, such as inspection of relevant documents or accounting records used by entity personnel in performing the control and/or observation of individuals performing the control.

Extent of a walkthrough

IG 12.9 Just as the extent of the auditor's understanding of the entity's processes is a matter of professional judgement, so too is the extent of the walkthroughs.

IG 12.10 In a first year audit, the auditor might perform walkthroughs of all of the entity's processes related to significant accounts and disclosures. In subsequent years, the extent of walkthroughs may be again evaluated, especially for non-complex processes. However, in those situations, the auditor's understanding of the process still needs to be accurate and complete and reflect any significant changes since the prior audit, because those changes might result in changes to his or her identification and assessment of risks of material misstatement and identification of relevant controls.

For example, when performing a walkthrough in a continuing audit, rather than walk through every step in the process, the auditor may instead focus inquiries on identifying any significant changes in the process or on validating that no significant changes have occurred.

For example, the auditor might inquire as to whether there have been any changes to the information and reports used in the process, changes to IT applications, or changes in the way entity personnel perform the steps in the process. [Note that inquiries are often used to obtain or update understanding of the steps in a process; however, for purposes of evaluating design and implementation of relevant controls in the process, inquiry alone is not appropriate and the auditor would corroborate his or her inquiries with other risk assessment procedures, such as inspection and observation.]

IG 12.11 Regardless of the approach the auditor takes to update his or her understanding of the process and relevant controls, he or she should evaluate the design and implementation of relevant controls in every audit by performing procedures in addition to inquiry.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

IG 13 Internal Financial Controls – Testing of Operative Effectiveness (Refer Paragraph 110 - 111)

IG 13.1 This Section provides an overview of testing the operating effectiveness of relevant controls. When testing the operating effectiveness of a control, the auditor obtains evidence about whether it is operating as designed.

IG 13.2 If a control is not designed properly, it cannot operate effectively; therefore, there is no need to test the operating effectiveness of controls that are improperly designed.

IG 13.3 The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

IG 13.4 If the control does not operate effectively (e.g., the auditor is unable to obtain sufficiently persuasive evidence that the control is operating as designed), then it is a “deficiency in operating effectiveness.”

IG 13.5 A deficiency in internal financial controls exists when the operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in operation exists when a properly designed control does not operate as designed, or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Process flow for testing operative effectiveness of controls



IG 13.6 This process flow illustrates the steps applicable to testing the operating effectiveness of a control. It is applied for each relevant control for which the auditor is required, or for which the auditor elects, to test operating effectiveness. Applying each of these steps requires professional judgement.

Assess the risks associated with the controls



IG 13.7 When the auditor has determined that it is necessary to test the operating effectiveness of a control, both for purposes of reporting on internal financial controls and when relying on the operating effectiveness of the control to reduce the extent of substantive procedures for purposes of the financial statement audit, he or she considers the risk associated with the control. The risk associated with the control is the risk that the control might not be effective. The assessment of risk associated with the control determines the persuasiveness of the evidence to be obtained about

III.626 Auditing Pronouncements

the effectiveness of the control. The auditor should assess the risk associated with the control as either “higher” or “not higher” and use this assessment to plan the nature, timing, and extent of the testing of each control.

IG 13.8 For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a significant deficiency or material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Factors considered when assessing the risk associated with the control

IG 13.9 Factors that affect the risk associated with a control include:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

Note: A less complex company or business unit with simple business processes and centralised accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

- The complexity of the control and the significance of the judgements that must be made in connection with its operation.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

Some of these factors relate to the risks of material misstatement that the control addresses, while others relate directly to the characteristics of the control itself. Therefore, it may be helpful to consider the factors in those two groups.

Factors related to the risks of material misstatement the control addresses

IG 13.10 The inherent risk associated with the risk of material misstatement

For example, controls that address risks of material misstatement that the auditor classifies as a significant risk have a higher risk associated with them, because determining the effective operation of such controls is more important due to the significance of the risks of material misstatement they address.

IG 13.11 The nature and materiality of misstatements that the control is intended to prevent or detect

For example, controls that address risks of material misstatement for accounts with smaller rupee values and routine transactions would typically have a lower risk associated with them than controls that address accounts with large transactions that occur on a non-routine basis.

IG 13.12 Whether there have been changes in the volume or nature of transactions that might adversely affect the controls design or operating effectiveness

For example, a significant increase in sales volume may stress the capacity of the manual controls that address the sales account, which likely increases the risk associated with such manual controls.

IG 13.13 Whether the account has a history of errors

For example, errors in an account are indicators that relevant controls that address the risks of material misstatement relating to such an account may not be operating effectively, which likely increases the risk associated with such controls.

Factors related to the characteristics of the control activity

IG 13.14 The complexity of the control and the significance of the judgements that must be made in connection with its operation

For example, controls that operate routinely, with little subjectivity, at the transaction level typically have lower risk associated with them as contrasted to highly subjective review-type controls that are complex because of the subject matter they address and the significant judgements involved (including the possibility for implicit or explicit bias in the reviewer's judgements in identifying deviations or differences for investigation and follow-up.)

IG 13.15 The effectiveness of entity-level controls, especially controls that monitor other controls

For example, if an entity effectively monitors the periodic preparation of account reconciliations throughout the year, the risk associated with the control may be lower.

IG 13.16 The nature of the control and the frequency with which it operates

For example, the auditor may assess the risk associated with controls that operate more frequently as lower than those that operate only on an ad hoc basis (e.g., controls related to accounting for an acquisition or a divestiture, when the entity enters into such transactions on an infrequent basis, may have a higher risk associated with them than other controls that operate more frequently and on a routine basis).

IG 13.17 The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or GITCs)

For example, automated controls depend upon the effectiveness of general IT Controls, and if such general IT controls are determined to be ineffective, the risk associated with the automated controls is likely to be higher.

IG 13.18 The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance

For example, if a new assistant controller is performing a control for the first time or if the person performing the control has not been trained either in how to perform the control or in the subject matter to which it pertains, there may be a higher risk associated with the control, as there is greater likelihood the control might not be performed appropriately, particularly as the complexity of the subject matter of the control increases (e.g., financial instruments).

IG 13.19 Whether the control relies on performance by an individual or is automated

For example, an automated control generally would be expected to have a lower risk associated with it when general IT controls (e.g., program change controls and security access controls) are effective.

IG 13.20 Although all of the factors listed above are potentially relevant when assessing the risk associated with a particular control, the auditor's consideration could begin with the inherent risk (i.e., whether or not the control addresses a significant risk of material misstatement) and the consideration of the complexity of the control and the significance of the judgements that must be made in connection with its operation will, in most cases, provide a sound foundation for consideration of the other factors.

For example, a control that comprises a three-way match (i.e., a control whereby invoices are matched to a valid purchase order and an approved packing slip or receiver) generally is not complex and requires minimal judgement in its operation, even if it is performed manually. Alternatively, a review-type control related to an asset impairment analysis performed by an impairment committee will be much more likely to have a higher risk associated with it, because much more can go wrong with the review of an asset impairment due to the complexity and significant judgements that are likely to be involved in the operation of the review. Accordingly the nature, timing, and extent of operating effectiveness tests for the three-way match and the review-type control will likely be different in order to respond to each of these controls' assessment of the risk that the control might not be effective.

Plan the nature, timing, and extent of tests of operating effectiveness of controls



IG 13.21 When the auditor plans the nature, timing, and extent of substantive tests, he or she designs substantive tests that address the risks of material misstatement. When the auditor plans the nature, timing and extent of tests of operating effectiveness of a relevant control that addresses one or more risks of material misstatement, he or she should design tests to address the risk associated with the control.

IG 13.22 As the risk associated with the control increases, the auditor may do one or more of the following:

- Increase the persuasiveness of the nature of the audit evidence that will be obtained from the tests (e.g., utilise a combination of procedure types or perform more persuasive procedures),
- Increase the extent of testing,
- Perform procedures closer to the balance sheet or obtain more persuasive evidence of the operation of the control during the roll forward period,
- Identify and test other redundant controls, and
- Perform the procedures themselves rather than using the work of others.

IG 13.23 The planning for tests of operating effectiveness begins with the detailed description of the control procedure [i.e., the details of how the control is performed (e.g., who, what, and when)] to determine which characteristics of each control need to be tested.

IG 13.24 When the auditor tests the design effectiveness of the control, he or she concludes whether the control procedure as documented is designed effectively. Testing operating effectiveness simply means testing to determine whether the control procedure was performed properly (i.e., whether all of the important steps or characteristics identified in the detailed control description, in fact, operated as designed or intended, and for the period of intended reliance).

IG 13.25 The characteristics of the control that the auditor considers when planning and performing tests of operating effectiveness also include IPE. In the case of tests of operating effectiveness of controls, IPE may include:

- IPE that a control is dependent upon: The auditor obtains evidence that such IPE is sufficiently reliable throughout the period of intended reliance.
- IPE that the auditor uses in tests of operating effectiveness of relevant controls: The auditor may obtain information to use in performing tests of certain controls, such as reports on system settings (e.g., access, profiles, passwords) or reports used to define

III.630 Auditing Pronouncements

the population of interest (e.g., a list of program changes). The auditor also performs procedures to test the accuracy and completeness of such IPE since the integrity of the tests of operating effectiveness of the relevant controls depends on the accuracy and completeness of that information.

IG 13.26 In addition to considering the risk associated with the control when planning the nature, timing, and extent of the operating effectiveness testing, the auditor also considers the requirement to introduce an element of unpredictability into the testing each year.

Nature of procedures

IG 13.27 Planning the nature of the operating effectiveness tests that the auditor is going to perform depends on two considerations:

(1) The risk associated with the control

The assessment of risk associated with the control influences the persuasiveness of the evidence that the auditor needs to obtain to support a conclusion that the control is operating effectively. Certain procedures will, by their nature, provide more persuasive evidence than other procedures. Inquiry alone will not provide sufficient appropriate audit evidence to conclude that a control is operating effectively. Depending on the auditor's assessment of the risk associated with the control and the nature of the control, auditor therefore performs other audit procedures in combination with inquiry, including observation, inspection of documentation, or re-performance of the control.

(2) The availability of evidence

When determining the nature of the procedures the auditor plans to perform, it is important to select procedures that will provide evidence that the control procedure operated as designed (i.e., address each of the important steps or characteristics of the control identified in the detailed control description). Obtaining evidence for only a portion of the control procedure (e.g., limiting tests of operating effectiveness to one step of the procedure, such as evidence of a sign-off) will often be insufficient evidence that the control operated as designed. Obtaining evidence of one step of the procedure (e.g., the sign-off) does not, in most cases, provide evidence of other relevant characteristics, including who performed the control and how it was performed (e.g., what the person performing the control analysed, reviewed, or did in support of his or her sign-off evidencing the completion of the control).

The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.
- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

Because evidence of operating effectiveness may be obtained from various activities (e.g., performing walkthroughs, testing design, using the work of others, and the auditor's own operating effectiveness testing), it is also important to clearly identify the nature of the evidence that the auditor plans to obtain and the location of that evidence, or the description thereof, in the working papers on risk of material misstatement or other working papers.

Timing of tests of controls

IG 13.28 The timing of tests of controls is typically influenced by the following considerations:

(1) The period that is to be covered by the tests

This consideration includes balancing the need to obtain evidence throughout the period for control-reliance purposes with obtaining sufficiently persuasive evidence nearer to or at the balance-sheet date in support of the opinion on internal financial controls. These objectives may be summarised as follows.

- Evidence obtained to support the opinion on internal financial controls: The auditor obtains audit evidence of the operating effectiveness of relevant controls at the balance-sheet date. Testing performed closer to the balance sheet date provides more evidence than testing performed earlier in the year and testing controls over a greater period of time provides more evidence of the effectiveness of controls than would be provided by testing the controls over a shorter period of time.
- Evidence obtained to support a control reliance strategy: When relying on operating effectiveness of controls to reduce extent of substantive testing, the auditor obtains audit evidence of the operating effectiveness of the control for the period of intended reliance.

Prior to the period end, the entity might implement changes to their controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor may consider how such changes affect reliance on controls for specific relevant assertions and the period of time in which the control was operating effectively. The auditor need not test the design and implementation and operating effectiveness of the superseded control for purposes of expressing an opinion on internal financial controls, however, he or she may decide to test the superseded control for purposes of relying on that control for specific relevant assertions over the period of time in which the control was effective.

(2) The risk associated with the control

The assessment of the risk associated with the control influences the timing of when the auditor obtains evidence. As the risk associated with the control increases, it may be more likely that the auditor will plan to test operating effectiveness without using roll forward procedures. Alternatively,

III.632 Auditing Pronouncements

if the auditor plans to use roll forward procedures, such procedures need to provide more persuasive evidence as the risk associated with the control increases.

(3) When the auditor chooses to perform the tests

The testing of the operating effectiveness of controls generally is performed after the control has operated. However, for some controls, it may be necessary to obtain the evidence when the control operates (or soon thereafter) as the evidence the auditor needs to perform the testing may not be accessible at a later date.

For example, the evidence of certain IT controls may exist only in the system. If the system is updated on a daily basis, the evidence may not be accessible after the control has operated. Similarly, a relevant control may comprise a meeting; if the auditor plans to obtain evidence of the operation of the control by attending the meeting, the auditor will not be able to obtain such evidence after the meeting has occurred.

The timing of the tests may also be affected by the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously or many times a day (e.g., controls over sales transactions), while others operate only at certain times or at periodic intervals (e.g., controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts) or even only after the balance-sheet date (e.g., controls over the preparation of certain notes to financial statements disclosures). Evidence of the operation of a control that relates to a period subsequent to the balance-sheet or period-end date cannot be considered evidence of its operating effectiveness at the balance-sheet or period-end date unless the control is designed to operate only after the balance-sheet date or period-end.

For example, as controls over the March 31, 20X5 year-end financial close and reporting process only operate in April 20X5, the auditor may use the evidence of the controls operating in April 20X5 to conclude on operating effectiveness of such controls "as of" March 31, 20X5.

When the auditor chooses to test the operating effectiveness of controls as of an interim date, there are typically two alternative approaches he or she may consider:

- Apportion the control test over the year (i.e., spread the total number of selections throughout the year). Under this approach, the operating effectiveness result is determined only upon completion of the test at year-end. Performing testing in this manner provides the basis to support conclusions as to the effectiveness of the controls throughout the period of intended reliance and as of the balance-sheet date. As the testing is apportioned over the entire year, roll forward procedures are not necessary.

For example, for a test of a relevant control using a sample size of 25, the auditor may choose to perform a portion of the test at interim date by selecting 20 items over the first nine months and then selecting the 5 remaining items in the fourth quarter. The auditor cannot reach a conclusion on the operating effectiveness of the control at the interim date (September 30) since he or she did not test all 25 items; the auditor can only reach a conclusion on the operating effectiveness of the control when the testing

of all sample selections is complete at year-end. Since the sample covered the entire period, the auditor is not required to perform separate roll forward procedures.

- Perform a complete test of the control (i.e., test all selections) at an interim date. This approach requires the auditor to perform sufficient testing to enable him or her to reach a preliminary conclusion regarding the operating effectiveness of the control tested at the interim date. Under this approach, additional procedures are required to be performed to assess the operating effectiveness of the control during the roll forward period or the balance-sheet date. The earlier in the year the interim tests are performed, the more persuasive the roll forward procedures will likely need to be, particularly when the risk associated with the control is higher.

For example, for a test of a relevant control using a sample size of 25, the auditor may choose to perform the entire test at interim date by selecting 25 items over the first nine months. Therefore, the auditor can reach a conclusion on the operating effectiveness of the control at the interim date (September 30) since the auditor tested all 25 items; however, the auditor needs to perform separate roll forward procedures to determine whether the control continues to be effective through the fourth quarter and near to or at the balance sheet date.

Extent of procedures

IG 13.29 Matters that may affect the necessary extent of testing of a control in relation to the degree of reliance on a control, in addition to the risk associated with the control, include the following factors:

- The frequency of the performance of the control by the entity during the audit period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control: Typically, for testing efficiency purposes, the auditor does not plan for deviations when designing the tests.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control: When the evidence the auditor plans to obtain is less persuasive (e.g., observing a control operate), the auditor may consider increasing the sample size.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion: This may relate to the evidence the auditor has about the effectiveness of other controls that monitor the control the auditor is testing, which may in turn provide a basis for lowering the assessment of risk associated with the control such that a lower extent of testing may be appropriate.
- The nature of the control, including, in particular, whether it is a manual control or an automated control: Automated controls are by nature more reliable than a manual control; however, their reliability depends on effective general IT controls — see next factor.

III.634 Auditing Pronouncements

- For an automated control, the effectiveness of relevant general IT controls: A reduced level of testing of an automated control is appropriate when effective general IT controls operate throughout the period of reliance. General IT controls help ensure the continued proper operation of information systems and support the effective functioning of application controls, including the automated controls. If general IT controls are not effective, then it is generally necessary to test the automated control at or near the balance-sheet date in support of the opinion on internal financial controls. However, even when effective general IT controls exist, automated controls are retested when changes are made to the control during the period in order to validate that the change was made appropriately and to test the control's effectiveness. Testing and relying solely on program change controls generally would not constitute direct evidence of the effectiveness of an automated control that had been changed.
- Higher risk associated with the control (including any control that addresses a significant risk).
- When one or more exceptions are identified that clearly indicate that the control is not operating effectively, it is generally not necessary to complete the test.

Dual-purpose tests

IG 13.30 In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "dual purpose test").

Typically, dual-purpose testing means that two tests, with different purposes and objectives, are planned to be performed concurrently and there may or may not be some level of "overlap."

For example, a substantive test of fixed-asset additions has the primary purpose of assessing whether the transaction selected for testing has been properly recorded in accordance with GAAP to validate occurrence, accuracy, and cut-off. The operating effectiveness test of relevant controls over fixed asset additions has the primary purpose of assessing whether the control(s) operated as designed which may include testing procedures or characteristics such as:

- i) Evidence of authorisation.
- ii) Review of the proper recording for occurrence, accuracy, and cut-off.
- iii) Process for follow up on exceptions.

Performing the substantive test may also include reperforming the review control (ii) but would likely not address control characteristics (i) or (iii).

There are two main objectives when using dual-purpose tests for control purposes:

Objective 1: The test directly provides evidence that the control procedure operated (i.e., it addresses the important steps and characteristics identified in the detailed control description).

Objective 2: The test is contemplated and documented as a dual-purpose test when the work was planned and performed, not after the fact, such that the documentation clearly demonstrates how the combined test addresses both the substantive test and internal control test objectives.

Auditor's planning to use dual-purpose testing are advised to carefully consider whether a single test results in obtaining sufficient appropriate audit evidence for both the intended substantive test and the control test or whether it would be more appropriate to design and apply separate procedures to the same sample selections that more specifically meet the applicable objectives of the substantive test and the control test. Also, the performance of substantive tests that results in no misstatements being identified does not provide sufficient evidence of the effectiveness of related controls. However, the identification of misstatements during the performance of substantive tests may indicate that related controls are not effective.

In certain situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.

Perform tests of operating effectiveness of controls



IG 13.31 Considerations when performing tests of operating effectiveness include:

- Clearly defining the test objective, including establishing a clear understanding of what constitutes a deviation.
- Identifying the population to be sampled.
- Selecting the sample such that all items in the population have a chance of selection.
- Obtaining sufficient and appropriate audit evidence, including related to IPE upon which the control is dependent.
- Applying professional scepticism when evaluating the persuasiveness of the evidence obtained, including what constitutes a deviation or exception.

As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates the auditor should consider, with an attitude of professional scepticism, both the subjective and objective factors.

The auditor considers the risk associated with the control when assigning personnel to perform testing (e.g., generally more experienced personnel may be assigned to test the more complex controls with significant judgements, while less experienced personnel may assist with performance of tests of less complex controls). Review of tests of controls (i.e., detailed, primary, overriding) is performed by team members who have sufficient knowledge of the entity's controls and risks to properly assess the planning and performance of the tests of controls, as well as the sufficiency of audit evidence to support the conclusions reached.

Testing review-type controls

IG 13.32 The auditor should assess the risk associated with review-type controls, whether performed by individuals or groups, as higher due to the subjectivity and complexity of such controls. Usually, the level of aggregation and the criteria for investigation are important characteristics of these types of controls. In addition, these controls are often dependent upon other controls or IPE. Accordingly, the testing for review-type controls would typically include a combination of procedures, such as:

- Inquiry of the persons involved in the performance of the control, including persons to whom questions are directed.
- Inspection of the reports and documents used in performing the control.
- Inspection of documentary evidence of conclusions reached and follow-up actions taken.
- Observation of meetings in which the control is performed.
- Re-performance of the review.

IG 13.33 Documentation associated with these controls often includes items such as meeting preparation materials, invitations sent to attendees, correspondence about issues discussed, and documentation of follow-up actions. However, such documentation commonly does not include descriptions of the discussions that are sufficient for the auditor to obtain evidence about the substance and completeness of the discussions and thought processes that led to the conclusions reached in the meeting (e.g., inquiry of participants and examination of calendars indicating that a meeting was held will not be sufficient evidence about the nature and effectiveness of the activities performed in the meeting).

Accordingly, observation of these meetings may be an important means of testing the effectiveness of the actual activities undertaken in the meeting. When observation is not possible (e.g., a meeting involving management's discussion with counsel regarding the reserve for legal matters), inspection of documentation evidencing that the important characteristics of the control were performed, if available, or re-performance of the control often are necessary to obtain sufficient persuasive evidence.

For example, a review-type control whereby the monthly financial results are discussed and differences are investigated has been identified as a relevant control for certain accounts that are stable and predictable. Inspecting evidence that the meeting occurred is generally not sufficient evidence to determine to what extent the other important characteristics of the control operated at the meeting, such as evidence of (1) the purpose of the control (operationally focused versus financial-reporting focused), (2) the depth of the discussion at an appropriate level of disaggregation, and (3) the criteria for investigation and the nature of items questioned, including the follow-up process.

IG 13.34 Evidence of matters identified for follow-up and their resolution often provides additional evidence of the performance of the review control. Inquiry of the persons performing the control in addition to documentation of such findings and follow-up will increase the reliability of the audit

evidence, while incomplete or altogether lacking documentation will diminish the reliability of audit evidence.

Accordingly, it may be useful to encourage management to retain documentation of reviews (e.g., notes, drafts, e-mails), including establishing a process for tracking matters identified for follow-up. In situations where there were no matters for follow-up, other procedures, such as observation, may be necessary to obtain sufficient evidence of effectiveness. It may be necessary to reconsider the effectiveness of a review-type control that seldom, if ever, identifies matters for follow-up, as this may be an indication that the control is not operating effectively or is not suitably designed to prevent or detect material misstatements.

IG 14 Sampling in Tests of Controls (Refer Paragraph 120)

IG 14.1 The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

IG 14.2 Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

IG 14.3 When planning a particular audit sample for a test of controls, the auditor should consider:

- The relationship of the sample to the objective of the test of controls.
- The maximum rate of deviations from prescribed controls that would support the planned assessed level of control risk.
- The auditor's allowable risk of assessing control risk too low.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

IG 14.4 For many tests of controls, sampling does not apply. Procedures performed to obtain an understanding of internal control sufficient to plan an audit do not involve sampling. Sampling generally is not applicable to tests of controls that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance. In addition, sampling may not apply to tests of certain documented controls. Sampling may not apply to tests directed toward obtaining evidence about the design or operation of the control environment or the accounting system. For example, inquiry or observation of explanation of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control.

IG 14.5 When designing samples for tests of controls the auditor ordinarily should plan to evaluate operating effectiveness in terms of deviations from prescribed controls, as to either the rate of such deviations or the monetary amount of the related transactions. In this context, pertinent controls are

III.638 Auditing Pronouncements

ones that, had they not been included in the design of internal control would have adversely affected the auditor's planned assessed level of control risk. The auditor's overall assessment of control risk for a particular assertion involves combining judgements about the prescribed controls, the deviations from prescribed controls, and the degree of assurance provided by the sample and other tests of controls.

IG 14.6 The auditor should determine the maximum rate of deviations from the prescribed control that he or she would be willing to accept without altering his planned assessed level of control risk. This is the tolerable rate. In determining the tolerable rate, the auditor should consider (a) the planned assessed level of control risk, and (b) the degree of assurance desired by the evidential matter in the sample. For example, if the auditor plans to assess control risk at a low level, and desires a high degree of assurance from the evidential matter provided by the sample for tests of controls (i.e., not perform other tests of controls for the assertion), he or she might decide that a tolerable rate of 5 percent or possibly less would be reasonable. If the auditor either plans to assess control risk at a higher level, or desires assurance from other tests of controls along with that provided by the sample (such as inquiries of appropriate entity personnel or observation of the application of the policy or procedure), the auditor might decide that a tolerable rate of 10 percent or more is reasonable.

IG 14.7 In assessing the tolerable rate of deviations, the auditor should consider that, while deviations from pertinent controls increase the risk of material misstatements in the accounting records, such deviations do not necessarily result in misstatements. For example, a recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorised and recorded. Deviations would result in misstatements in the accounting records only if the deviations and the misstatements occurred on the same transactions. Deviations from pertinent controls at a given rate ordinarily would be expected to result in misstatements at a lower rate.

IG 14.8 In some situations, the risk of material misstatement for an assertion may be related to a combination of controls. If a combination of two or more controls is necessary to affect the risk of material misstatement for an assertion, those controls should be regarded as a single procedure, and deviations from any controls in combination should be evaluated on that basis.

IG 14.9 Samples taken to test the operating effectiveness of controls are intended to provide a basis for the auditor to conclude whether the controls are being applied as prescribed. When the degree of assurance desired by the evidential matter in the sample is high, the auditor should allow for a low level of sampling risk (that is, the risk of assessing control risk too low).

IG 14.10 To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or non-statistical approach is used. Thus, when a non-statistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

The auditor may also apply the provisions of Standard on Internal Audit (SIA) 5 on “Sampling” and the sample sizes indicated in Appendix 4 of the above Standard. Refer the full text of SIA 5 in **Appendix VI** to this Guidance Note.

Sample selection

IG 14.11 Sample items should be selected from the appropriate population that is representative of the risk being tested. For example, a risk that sales may not be recorded for all goods despatched (relevant to the assertion ‘completeness’) should be tested based on the population of despatch documents and not from the population of recorded sales. Similarly for testing the risk of sales being recorded without corresponding despatch of goods (relevant to the assertions ‘existence’ and ‘cut off’), the sample should be selected from the recorded population of sales. Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit.

Assess findings and conclude on the operating effectiveness of controls



IG 14.12 Considerations when assessing findings and concluding on the operating effectiveness of controls include:

- Determining whether a deviation is identified.
- Determining the nature and cause of the deviation(s).
- Evaluating whether the deviation is a control deficiency.

IG 14.13 When the auditor identifies a deviation (or exception), he or she should consider the circumstances and reasons for the deviation and evaluate the effect of the deviation to determine whether:

- The tests of controls that have been performed provide an appropriate basis for reliance on the controls (e.g., the deviation is not a deficiency);
- To obtain additional evidence to obtain a better estimate of the projected deviation rate to determine if the deviation is a deficiency (e.g., the auditor may consider increasing sample sizes which, since a deviation was identified, would include considering whether to increase the risk associated with the control); or
- The deviation is a deficiency and in the absence of other redundant or compensating controls, the potential risks of misstatement need to be addressed using substantive procedures (e.g. the control is not effective and thus control reliance is not appropriate).

Determining whether a deviation exists

IG 14.14 In designing an audit sample to test controls, the auditor defines the objective of the audit procedure (i.e., the test objective) and the characteristics of the population from which the sample will be drawn. The determination of the objective of a test of a control includes a clear understanding of what constitutes a deviation so that all, and only, those deviations that are relevant to the purpose of the test are included in the evaluation of deviations.

IG 14.15 Generally, any failure in the operation of a control from (1) established policy and procedure, (2) a regulatory requirement or (3) the expectation of the operation based on peer or industry comparison is likely a deviation (which is then further evaluated as described below). Examples of instances in which a failure in the operation of a control may not be a deviation may include the following circumstances:

- When the control operates effectively in mitigating the risk, even though the control does not operate completely in accordance with the prescribed procedure (e.g., an authorisation form was not properly completed and signed off, but there is other evidence that clearly reflects the transaction was authorised).
- When the departure from policy or procedure is authorised by the appropriate level of management based on particular circumstances (e.g., in an employee's absence, the normal control process was not followed; however, management is aware of this and has compensated for it).
- If a document is selected that has been validly cancelled prior to operation of the control (i.e., the document does not constitute a deviation), it may be excluded from the sample and an appropriately chosen replacement may be examined. However, if the deviation relates to a document that cannot be located, the auditor makes every possible effort to locate it or to ascertain, using suitable alternative procedures that the control in this specific instance was operating properly. If evidence supporting operation of the control for the selected sampling unit is not available, another sampling unit cannot be substituted for the missing unit and it is generally necessary to treat this item as a deviation from the prescribed control.

Determining the nature and cause of the deviation

IG 14.16 When investigating the nature and cause of a deviation, the auditor may consider the following questions:

- Is the nature of the deviation limited to certain types of transactions (e.g., infrequent exceptions as opposed to the norm)? The auditor should consider the nature and volume of the exceptions that may be subject to other deviations.
- Has a change in roles or responsibilities of the person performing or monitoring the control contributed to the deviation? The auditor should consider the significance and breadth of the role and responsibility of the new person and the likelihood that other deviations in other controls operated by the new person could exist.

- Has a lack of competency of the person performing the control contributed to the deviation? The auditor should consider the significance and breadth of the role and responsibility of the person for which other deviations could exist.
- Was management aware of the circumstances causing the deviation? A deviation that management is not aware of and not monitoring may result in an increased likelihood that other deviations will occur.
- Have changes in volume of activity or transactions (e.g., significant seasonal fluctuations) contributed to the deviation? A deviation during a limited period of heavy volume may not be indicative of what might more typically occur during normal volume periods.

Evaluate whether the deviation is a control deficiency

IG 14.17 The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error. Accordingly, it is acknowledged that a control could still be concluded to be effective, even when some level of deviation may exist. Because effective internal financial controls cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

IG 14.18 The following considerations are relevant when considering the level of "acceptable" deviations (i.e., such that a control deficiency does not exist):

- Risk associated with the control: The higher the risk, the more reliable the control needs to be.
- Extent of reliance on the control: When a risk of material misstatement is addressed solely by one control, the control generally needs to be more reliable, particularly when the risk being addressed is a significant risk.
- Testing approach: When the auditor tests the operating effectiveness of a control by sampling, the sample sizes are based on an acceptable tolerable deviation rate; therefore, when the auditor discovers more deviations than planned for, the test objective is generally not met. At this point the auditor cannot conclude the control is effective and therefore, the existence of deviations beyond what was planned for would generally represent a deficiency, in absence of performing additional testing. The auditor may then consider whether additional testing is necessary or appropriate. For controls that operate less frequently, given the small sample sizes, the auditor typically would not expand the sample size.

For example, if a test of a control that operates many times a day is designed to not allow for any deviations and the actual number of deviations is one or more, the test objective is generally not met. The auditor may either conclude that the control is not effective or may decide to increase the sample sizes to obtain a better estimate of the projected deviation rate, in which case, the auditor should also reconsider whether to increase the risk associated with the control.

III.642 Auditing Pronouncements

- If the auditor is able to test the entire population, he or she uses professional judgement to determine whether the actual deviation rate is indicative of a deficiency based on the risk associated with the control (e.g., an actual deviation rate up to 5 percent may be concluded to be acceptable).

For example, the auditor assessed the appropriateness of access privileges for all 300 system users and noted 3 exceptions. The auditor evaluated the exceptions qualitatively and noted no significant concerns as the 3 users' inappropriate access was limited to one application. As it is not expected that the control would operate without deviation, and as the actual rate of deviation in the entire population is quantified or known (3 out of 300, or 1percent), the auditor may conclude that the deviation rate is acceptable and not indicative of a deficiency.

- Nature of the control: Relevant points when considering the nature of the control include:
 - The relative importance of the deviations to the overall performance of the control (i.e., the deviation is related to only one of many characteristics or attributes tested when assessing the related control).

For example, review controls typically have multiple characteristics that need to be tested; therefore, testing of such controls may result in deviations related to certain characteristics and not others. Determining whether such controls are nevertheless effective, even if some level of deviation has been identified, requires significant professional judgement.
 - Whether misstatements have actually occurred.
 - Whether the deviation has a potential effect on the effectiveness of other controls.

IG 14.19 Based on the above considerations, deviations are evaluated and concluded upon to be either:

- Only a deviation and not a deficiency: In this case, no further consideration is necessary (this is expected to be rare, particularly when the auditor is using a sampling approach); or
- A deficiency: In this case, the deficiency is further evaluated to assess its severity and implications on the financial statements audit (i.e., risk assessment and control reliance strategy).

IG 15 Roll Forward Testing (Refer Paragraph 121)

IG 15.1 This Section highlights considerations when the auditor rolls-forward the conclusions of the effectiveness of those relevant controls which were tested and concluded to be effectiveness as at an interim date. The roll forward procedures to be performed and evidence to be obtained are based on the auditor's assessment of certain factors related to the risk that controls that have been tested as of an interim date will not continue to operate effectively during the roll forward period. The roll forward period (also sometimes referred to as the "remaining" period) is the period from the

date of the interim conclusion about the effectiveness of a control up to, and including, the balance sheet date for the report on internal financial controls.

IG 15.2 The auditor typically performs procedures to understand the likely sources of misstatements and conclude on design effectiveness at an interim date for many of the relevant controls. The roll forward procedures the auditor performs are focused on changes to the business or the entity's financial reporting that may give rise to a new risk or may affect an existing risk of material misstatement, which, in turn, would necessitate the entity's implementing new controls or modifying the design of existing controls.

IG 15.3 The auditor may also decide to perform tests of operating effectiveness of relevant controls at an interim date. Timing of tests of controls and the necessity of performing roll forward procedures to update conclusions about operating effectiveness of relevant controls depends on which testing approach the auditor applies:

- Apportion the test of operating effectiveness of a relevant control over the year, or
- Perform a complete test of the operating effectiveness of a relevant control (i.e., test all selections) at an interim date and conclude as to the effectiveness of the control as of the interim date.

IG 15.4 When the auditor apportions the control test over the year, he or she does not need to plan roll forward procedures because the testing plan will include selections up to or near the balance sheet date. However, when the auditor performs a complete test at an interim date, he or she has to perform procedures to roll forward those conclusions to the balance sheet date to support the opinion on the effectiveness of internal financial controls and to support reliance on controls for substantive purposes (i.e., to reduce the evidence the auditor needs to obtain from the substantive procedures).

IG 15.5 There are factors to be considered when making such determination. Because controls have different characteristics and operate with differing levels of reliability, these factors are considered for each relevant control to determine the persuasiveness of the evidence the auditor needs to obtain to conclude that a control continues to operate effectively through the balance sheet date (i.e., to support the opinion on the effectiveness of internal financial controls and to support the reliance on controls for substantive purposes). The auditor plans the nature, timing, and extent of the roll forward procedures for each relevant control (or groups of controls that possess similar characteristics) tested as of an interim date based on the consideration of the factors.

Key activities in the process for planning and performing procedures to roll forward conclusions of design and operating effectiveness

IG 15.6 Key activities for planning procedures to roll forward interim conclusions of design and operating effectiveness:

- Identify relevant controls which were tested (i.e., both design and operating effectiveness were tested) and concluded at interim date and therefore subject to roll forward procedures.

III.644 Auditing Pronouncements

- Consider management's ongoing monitoring processes and activities to identify changes that may give rise to new risks of material misstatement or modifications to existing risks, as well as new controls, or modifications to existing controls.
- Consider the evidence obtained by management during the roll forward period related to the controls that were tested at an interim date.
- Plan the nature, timing, and extent of the roll forward procedures.

IG 15.7 Key activities for performing procedures to roll forward interim conclusions of design and operating effectiveness:

- Perform procedures to determine whether there have been any significant changes to the business or the entity's financial reporting that would give rise to new or affect existing risks of material misstatement, which would necessitate the entity's implementing new controls or modifying the design of existing controls.
- Test the design and operating effectiveness of new or modified relevant controls.
- Obtain appropriate evidence of operating effectiveness that the controls tested at interim date continue to operate effectively for the roll forward period.
- Document the roll forward procedures performed, basis for professional judgements, and conclusions for each of the relevant controls.
- Log any deficiencies for classification as to severity and further evaluation of their impact on the risk assessment and audit of the financial statements.

Plan roll forward procedures

IG 15.8 Factors to consider when planning roll forward procedures:

The additional evidence that is necessary to roll forward the interim conclusion about the operating effectiveness of each relevant control tested as of an interim date is based on consideration of the factors as explained in more detail in the discussion that follows.

IG 15.9 The specific control tested prior to the balance sheet date, including the risk associated with the control and the nature of the control, and the results of the tests.

IG 15.10 The higher the risk associated with the control (which includes considerations related to the nature of the control and the results of tests of such control in prior years and the current year to date), the more persuasive the evidence the auditor needs to obtain from the roll forward procedures.

For example, the auditor would design more persuasive roll forward procedures for a control where he or she has assessed the risk associated with the control as "higher."

IG 15.11 The auditor may also need to obtain more persuasive evidence from the roll forward procedures when the risk associated with a control is assessed as "not higher."

For example, if the risk associated with a control related to a review-type control (or a more subjective control) in the revenue process has been assessed as "not higher," the auditor may nonetheless conclude that more persuasive evidence is needed during the roll forward period due to the subjectivity of the operation of the control. In contrast, the auditor may decide that he or she

needs less persuasive evidence for a routine control in the payroll process where the risk associated with the control is assessed as “not higher,” and the control has operated effectively in the past with no changes identified during the roll forward period that may affect the operation of the control.

IG 15.12 The sufficiency of the evidence of effectiveness obtained at an interim date

This factor means that the more persuasive the evidence that has been obtained to support conclusions reached at an interim date, the less persuasive the evidence that may be needed for the roll forward period.

For example, performing procedures such as inspection of documentation or re-performance may produce more persuasive evidence of the operating effectiveness of a relevant control at an interim date, and accordingly, the auditor may decide that procedures that produce less persuasive evidence (such as inquiry or observation) are appropriate for the roll forward period. However in certain circumstances (e.g., for controls where the risk associated with the control is higher), the auditor may decide that notwithstanding that more persuasive evidence was obtained as of the interim date, he or she would also need to obtain more persuasive evidence for the roll forward period.

IG 15.13 The length of the remaining period

As the length of the remaining period increases, the more persuasive the evidence that may be needed from the roll forward procedures (e.g., when the roll forward period exceeds three to four months) and the less likely that the auditor will be able to conclude that roll forward procedures that are comprised of inquiry alone are sufficient. Additionally, for certain controls (e.g., controls where the risk associated with the control is higher) for which the interim testing was completed within three to four months prior to the balance sheet date, performing additional roll forward procedures (i.e., beyond inquiries) may, nonetheless, be necessary.

IG 15.14 The possibility that there have been any significant changes in internal financial controls subsequent to the interim date

This factor is in the context of whether there are significant changes in the business during the roll forward period that could impact the operating effectiveness of the relevant controls that the auditor tested as of an interim date (e.g., changes in the person performing the control); in this case, more persuasive evidence may be necessary to determine that the controls continued to operate effectively during the roll forward period.

For example, subsequent to the interim testing, a new Controller is hired who had no previous experience with the entity or its processes and controls; however, given the nature of the role and the related responsibilities, this new person is responsible for the operation of certain relevant controls. The auditor would consider the nature of each of the controls for which the Controller is responsible, and determine whether more persuasive evidence of continued operating effectiveness during the roll forward period is necessary, given the Controller’s inexperience relative to the entity’s business and the controls (which may require retesting the controls), as they are equivalent to the implementation of “new controls.”

IG 15.15 The planned degree of reliance on the control

III.646 Auditing Pronouncements

This factor means that more persuasive evidence may be necessary from the roll forward procedures when (1) a relevant control is the only control mitigating a risk of material misstatement (i.e., as opposed to one of a combination of controls that might collectively address the risk) or (2) the auditor is relying on the control to reduce the extent of the substantive procedures (i.e., take a control reliance approach).

Planning the approach to roll forward procedures

IG 15.16 The auditor should assess each of the factors identified in paragraphs IG 15.8 to IG 15.15 above for each relevant control tested as of an interim date (or groups of controls that possess similar characteristics) to determine:

- Whether inquiry alone is sufficient evidence of the continuing operating effectiveness; or
- Whether additional procedures beyond inquiry alone are necessary and, if so, the auditor considers the nature, extent, and timing of those procedures.

IG 15.17 After determining whether inquiry alone is sufficient or whether additional procedures need to be performed, the auditor should then plan the nature, extent, and timing of the roll forward procedures. The following two examples of approaches to planning roll forward procedures are discussed below:

- When inquiry alone is sufficient evidence of the continuing operating effectiveness of relevant controls tested as of an interim date.
- When additional procedures beyond inquiry are necessary.

IG 15.18 When inquiry alone is sufficient evidence of the continuing operating effectiveness of relevant controls tested as of an interim date

There may be a portion of the controls tested as of interim dates (and for which the auditor needs to update the interim conclusions) where (1) the risk associated with the controls is assessed as “not higher” (e.g., the controls are routine in nature, typically operating many times a day and with a history of operating effectively) and (2) the roll forward period is sufficiently short (e.g., typically no more than three to four months). In this case, the auditor may determine that there is a sufficiently low risk that these controls will be ineffective during the roll forward period such that inquiry alone may provide sufficiently persuasive evidence.

For example, the auditor tested within three months before the balance sheet date certain payroll controls that operate routinely many times a day (risk associated with the controls is “not higher”). The auditor concluded that inquiry alone will be sufficiently persuasive to update the interim conclusions through the remaining period. However, as the length of the roll forward period increases (e.g., extending beyond three to four months prior to the balance sheet date), the more likely it will be necessary for the roll forward procedures to include additional procedures beyond inquiry.

IG 15.19 When additional procedures beyond inquiry are necessary

For those controls tested as of an interim date where the auditor has concluded that additional procedures beyond inquiry are necessary to roll forward the interim conclusions, he or she may consider segregating the controls as follows:

- a. For controls where the auditor has assessed risk associated with the control as “higher” (including controls that address significant risks), the auditor typically plans to perform more extensive additional procedures for each of these controls, given the higher risk associated with the control.

For example, a manual control related to complex revenue transactions, where the risk associated with the control has been assessed as “higher”, (due to the complexity and subjectivity of the judgements involved), was tested through the third quarter and found to be effective. The roll forward procedures consist of performing inquiries combined with appropriately extensive additional procedures (e.g., observation, inspection of documentation or re-performance).

- b. For controls where the auditor has assessed risk associated with the control as “not higher”, the auditor typically plans to perform less extensive additional procedures for each of these controls. It is generally not appropriate to only select a sample of these controls to test in the roll forward period and then extrapolate the results of that testing to the remaining population of controls not tested.

For example, 30 relevant controls for which the risk associated with the control has been assessed as not higher are tested six months prior to the balance sheet date. Given the length of the remaining period, inquiry alone was determined to provide insufficient evidence. Accordingly, the auditor plans to perform additional procedures, in addition to inquiry, to obtain evidence that each of the 30 controls continue to operate effectively during the roll forward period.

Alternatively, when management has effective ongoing monitoring activities that directly monitor the controls for which the auditor is seeking to obtain evidence during the roll forward period, the auditor may test the design and operating effectiveness of the monitoring controls, which may include selecting and testing a sample of the controls that he or she is rolling forward in order to provide evidence of the effectiveness of the monitoring controls.

Perform roll forward procedures

IG 15.20 The objective of the roll forward procedures is to identify whether (1) any changes to the business occurred that could give rise to new, or affect existing risks of material misstatement, which would necessitate implementing new controls or modifying the design of existing controls and (2) existing controls continue to operate effectively during the roll forward period. Accordingly, the procedures the auditor typically performs at this phase include a mix of inquiry, observation, inspection of documentation, and re-performance to obtain sufficient evidence to determine whether changes have occurred. The evidence the auditor seeks to gather generally consists of:

- Evidence from management’s ongoing monitoring and risk assessment processes to identify and manage change. If there have been changes that affect the design or operating effectiveness of a control, either manual or automated controls, during the

III.648 Auditing Pronouncements

roll forward period, the auditor is required to obtain audit evidence about the effectiveness of the new or modified control without giving consideration to the evidence the auditor had obtained before the change occurred.

- Evidence from the planned roll forward tests of operating effectiveness.
- The determination of sample sizes for roll forward procedures is a matter of judgement considering the factors mentioned above. The auditor may also consider using the work of others, when applicable and appropriate.
- Evidence from the other auditing procedures.

Documentation considerations in roll forward procedures

IG 15.21 The purpose of this Section is to provide auditors with documentation considerations relative to planning and performing roll forward procedures.

Considerations include:

- i) A description of the planned procedures that clearly describes the (a) nature, (b) timing, and (c) extent of roll forward procedures for each control, including procedures to test relevant IPE.
- ii) Assessment of monitoring controls that the auditor intends to test and rely upon, including the rationale for how the controls selected to corroborate the operating effectiveness of the monitoring controls were chosen, giving consideration to the different business processes and controls within the business process and how that sample is representative of the population.
- iii) The roll forward procedures performed and the evidence obtained, including:
 - A description of the procedures performed, including whether they were inquiry, observation, examination of documents, re-performance, or some combination. The documentation of inquiries includes (1) to whom the auditor made inquiries, (2) the specific inquiries made, and (3) the results of those inquiries.
 - When the interim testing of the controls was performed (e.g., the month or quarter).
 - Identification of and reference to testing of any IPE.
 - A statement that there were no exceptions or a clear description of any deviations noted.
- iv) The procedures, findings, and conclusions related to assessing findings and concluding on design and operating effectiveness, including:
 - A clear statement about whether the control is effectively designed and operated.
 - If auditor's conclusion is that the control is ineffective, consideration of the effect of the conclusion on tests of other controls that may depend on the control tested and the design of the substantive tests.

- The basis for the conclusions reached.

IG 16 Rotation Plan for Testing Internal Financial Controls (Refer Paragraph 118 and 125)

IG 16.1 Rotation plan for testing of internal controls may be relevant to efficiently perform an audit of internal financial controls. One of the important consideration in this regard is that control environment within a company is somewhat enduring in nature and hence in case there are no changes in the underlying controls the auditors may be able to leverage on the work carried out in the previous periods. The internal control testing work can broadly be categorised into following:

- Understanding the process flows.
- Testing design and implementation of controls.
- Testing operative effectiveness of controls.

IG 16.2 From the perspective of adopting a rotation plan for testing of internal controls, understanding the process flows and testing design and implementation of controls are required to be covered in every audit period. However, a rotation plan may be considered for testing operating effectiveness of controls subject to the criteria specified in paragraph IG 16.3 below.

IG 16.3 The following is the broad criteria to be met for adopting a rotation plan for testing operating effectiveness of controls:

- The auditor may be able to utilise the tests of controls performed in prior audits in the current audit. In determining the strategy for testing the operating effectiveness of controls upon which the auditor intends to rely, the auditor may plan an approach whereby he or she will use audit evidence about operating effectiveness of certain controls obtained in previous audits in combination with the evidence obtained from the understanding of controls in the current audit and tests of operating effectiveness of other controls performed in the current audit.
- In these circumstances, the auditor is required to establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.
- The auditor is required to obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls.
- If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor is required to test the controls in the current audit.
- If there have not been such changes, it is recommended that the auditor tests the controls at least once in every third audit and need to test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

IG 17 Remediation Testing (Refer Paragraph 119)

IG 17.1 Auditors are required to express an opinion on the effectiveness of the entity's internal financial controls as of the balance sheet date.

IG 17.2 Accordingly, any issues or deficiencies either relating to design or operative effectiveness of controls if they are remediated before the period under consideration, then the auditor can still express an unqualified opinion. It would be important to note that the remediation has to happen within the financial period which is under consideration.

IG 17.3 Sufficient time should be allowed to evaluate and test controls. If deficiencies are discovered, management may have the opportunity to correct and address these deficiencies prior to the reporting date. However, once a new control is in place, management should allow enough time for its operations to validate the control's operating effectiveness. The amount of time that a control should be in place and operating effectively depends on the nature of the control and how frequently it operates. The amount of time a remediation control should be in existence for placing reliance on the control by the auditor is a matter of professional judgement. Under ordinary circumstances, control remediation that occurs after year-end will not mitigate an identified deficiency for reporting purposes. Auditor should not express an opinion on management's disclosure about corrective actions taken by the company after the balance sheet date.

IG 18 Using the Work of Internal Auditors and an Auditor's Expert (Refer Paragraph 82 - 85)

IG 18.1 The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the auditor are different insofar as it relates to financial statements, the ways in which the internal audit function and the auditor achieve their respective objectives in an audit of internal financial controls may be similar.

IG 18.2 The auditor's consideration of the internal audit function in an audit of internal financial controls, applies in a combined audit of internal financial controls over financial reporting and financial statements.

IG 18.3 The objectives of the auditor, where the entity has an internal audit function that the auditor has determined is likely to be relevant to the audit, are to determine:

- (a) Whether, and to what extent, to use specific work of the internal auditors; and
- (b) If so, whether such work is adequate for the purposes of the audit.

IG 18.4 In determining whether and to what extent to use the work of the internal auditors, the auditor shall determine:

- (a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and
- (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the auditor's procedures.

IG 18.5 The auditor should apply the requirements of paragraphs 8, 9 and A4 of SA 610 “Using the Work of Internal Auditors” to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

IG 18.6 The auditor may also use the work of an auditor’s expert in an audit of internal financial controls. In this regard the auditor should apply the requirements of SA 620 “Using the Work of an Auditor’s Expert”.

IG 18.7 Auditor’s expert is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor’s expert may be either an auditor’s internal expert (who is a partner or staff, including temporary staff, of the auditor’s firm or a network firm), or an auditor’s external expert.

IG 18.8 The key considerations for an auditor in using the work of an auditor’s expert are:

- Determining the need for the expert.
- Nature, timing and extent of audit procedures to be performed by the expert and the auditor.
- The competence, capability and objectivity of the auditor’s expert.
- Obtaining an understanding of the field of expertise of the auditor’s expert.
- Agreement with the auditor’s expert.
- Evaluating the adequacy of the auditor’s expert’s work.

IG 18.9 The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

IG 19 Additional Considerations for Auditing Internal Financial Controls Over Financial Reporting

IG 19.1 The complexity of a company is an important factor in the auditor’s risk assessment and determination of the necessary audit procedures. Customising the audit is important for audits of internal control of all companies, especially smaller, less complex companies.

IG 19.2 The audit of internal financial controls should be integrated with the audit of the financial statements, so the auditor must plan and perform the work to achieve the objectives of both audits. This direction applies to all aspects of the audit, and it is particularly relevant to tests of controls.

Customising the audit of internal financial controls

IG 19.3 Customising the audit of internal financial controls involves tailoring the audit approach to fit the individual facts and circumstances of the company. Many smaller companies have less complex operations, and they typically share many of the following attributes:

- Fewer business lines.
- Less complex business processes and financial reporting systems.

III.652 Auditing Pronouncements

- More centralised accounting functions.
- Extensive involvement by the owners and senior management in the day-to-day activities of the business.
- Fewer levels of management, each with a wide span of control.

IG 19.4 The attributes of a smaller, less complex company can affect the particular risks that could result in material misstatement of the company's financial statements and the controls that a company might establish to address those risks. Consequently, these attributes have a pervasive effect on the audit of internal financial control, including assessing risk, determining significant accounts and disclosures and relevant assertions, selecting controls to test, and testing the design and operating effectiveness of controls. The following are examples of internal control-related matters that might be particularly affected by the attributes of a smaller, less complex company –

- Use of entity-level controls to achieve control objectives. In smaller, less complex companies, owners and / or senior management are often involved in many day-to-day business activities and perform duties that are important to effective internal financial controls. Consequently, the auditor's evaluation of entity-level controls can provide a substantial amount of evidence about the effectiveness of internal financial controls.
- Risk of management override. The extensive involvement of owners and/or senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls or intentionally misstate the financial statements in smaller, less complex companies. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor should consider the risk of management override and company actions to address that risk in connection with assessing the risk of material misstatement due to fraud and evaluating entity-level controls.
- Implementation of segregation of duties and alternative controls. By their nature, smaller, less complex companies have fewer employees, which limit the opportunity to segregate incompatible duties. Smaller, less complex companies might use alternative approaches to achieve the objectives of segregation of duties, and the auditor should evaluate whether those alternative controls achieve the control objectives.
- Use of Information Technology (IT). A smaller, less complex company with less complex business processes and centralised accounting operations might have less complex information systems that make greater use of off the shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the testing of IT general controls might focus on those controls that are important to the effective operation of the selected application controls.
- Maintenance of financial reporting competencies. Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals. The auditor may take into consideration the use of those third parties when assessing financial reporting competencies of the company.

- Nature and extent of documentation. A smaller, less complex company typically needs less formal documentation to run the business, including maintaining effective internal financial controls. The auditor may take that into account when selecting controls to test and planning tests of controls.
- In some audits of internal control, auditors might encounter companies with numerous or pervasive control deficiencies. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls. The auditor's strategy can be influenced by the nature of the control deficiencies and factors such as the availability of audit evidence and the effect of the deficiencies on other controls.

Test of controls in a combined audit of internal financial controls over financial reporting and financial statements

IG 19.5 Selection of controls to test

Appropriate selection of controls helps focus the auditor's testing on those controls that are important to the auditor's conclusion about whether the company's internal financial controls are effective. The decision about whether to select a control for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement in a given relevant assertion rather than on how the control is labelled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control).

A practical starting point for identifying these controls, is to consider the controls that management relies on to achieve its objectives for reliable financial reporting. Besides the overriding consideration of whether a control addresses the risk of misstatement, as a practical matter, the auditor might also consider the following factors when selecting controls to test:

- Is the control likely to be effective?
- What evidence exists regarding operation of the control?

When selecting controls to test, the auditor could seek to select controls that are more likely to be effective in addressing the risk of misstatement in one or more relevant assertions. If none of the controls that are intended to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion.

The auditor needs to be able to obtain enough evidence about a control's operation to conclude on its effectiveness. The auditor could take into account the nature and availability of audit evidence when selecting controls to test and determining the nature, timing, and extent of tests of controls. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor may select the control for which evidence of operating effectiveness can be obtained more readily.

IG 19.6 Tests of operating effectiveness of controls

Historically, the approach for financial statement audits of smaller, less complex companies has been to focus primarily on testing accounts and disclosures, with little or no testing of controls.

III.654 Auditing Pronouncements

Auditors have the latitude to determine an appropriate testing strategy to –

- (a) Obtain sufficient evidence to support the auditor's opinion on internal financial controls as of year-end, and
- (b) Obtain sufficient evidence to support the auditor's control risk assessments in the audit of the financial statements.

To express an opinion on internal financial controls taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant financial statement assertions. Because the auditor's opinion on internal financial controls is as of a point in time, he or she should obtain evidence that internal financial controls has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements.

In an audit of financial statements, the objective of tests of controls is to assess control risk. To assess control risk at less than the maximum, the auditing standards require the auditor to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions, and, for a variety of reasons, the auditor may choose not to do so.

The auditor's assessment of control risk at the maximum for one or more relevant assertions in an audit of financial statements does not necessarily preclude the auditor from issuing an unqualified opinion in an audit of internal control. The objectives of the two audits are not identical. The auditor could obtain sufficient evidence to support his or her opinion on internal financial controls, even if the auditor decides not to test controls over the entire period of reliance to support a control risk assessment below the maximum. However, if the auditor assesses control risk at the maximum because of identified control deficiencies, the auditor should evaluate the severity of the deficiencies, individually or in combination, to determine whether a significant deficiency or material weakness exists.

The auditor's decision about relying on controls in an audit of financial statements may depend on the particular facts and circumstances. In some areas, the auditor might decide to rely on certain controls to reduce the substantive testing of accounts and disclosures. For other areas, the auditor might perform primarily substantive tests of the assertions without relying on controls. For example, the auditor might test a company's controls over billings and cash receipts processing to cover the entire period of reliance in order to reduce the extent of confirmation of accounts receivable balances but might perform primarily substantive tests of the allowance for doubtful accounts. In this case, the auditor might perform the tests of controls over the allowance for doubtful accounts only as necessary for the audit of internal financial controls.

For some significant accounts, the auditor might decide that a relevant assertion can be tested effectively and efficiently through substantive procedures without relying on controls. For example, the auditor might decide to confirm an outstanding loan payable with the lender rather than rely on controls. In that situation, the auditor may test controls of the relevant assertions only as necessary to support his or her opinion on the company's internal financial controls at year-end.

To obtain evidence about whether a selected control is effective, the control must be tested; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, is one of a number of factors that inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Evaluating entity-level controls

IG 19.7 An important aspect of performing an audit of internal financial control is the process of identifying and evaluating entity-level controls. This Section discusses entity-level controls and explains how they can affect the nature, timing, and extent of the auditor's procedures in an audit of internal financial control for a smaller, less complex company.

IG 19.8 For the purposes of this discussion, entity-level controls are controls that have a pervasive effect on a company's internal control. These controls include:

- *Controls related to the control environment;*
- *Controls over management override;*
- *The company's risk assessment process;*
- *Centralised processing and controls, including shared service environments;*
- *Controls to monitor results of operations;*
- *Controls to monitor other controls, including activities of the audit committee and self-assessment programs;*
- *Controls over the period-end financial reporting process; and*
- *Policies that address significant business control and risk management practices.*

In smaller, less complex companies, owner and/or senior management often is involved in many day-to-day business activities and performs many controls – including entity-level controls – that are important to effective internal financial controls. When this is the case, the auditor's evaluation of entity-level controls can be an important source of evidence about the effectiveness of internal financial controls.

Effective controls related to the control environment and controls that address the risk of management override are particularly important to the effective functioning of controls performed by senior management.

Auditors might find that limited formal documentation is available regarding the operation of some entity-level controls.

Identifying entity-level controls

IG 19.9 The process of identifying relevant entity-level controls could begin with discussions between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal financial controls (e.g., control environment, risk assessment, control activities, monitoring, and information and communication).

While evaluating entity-level controls, auditors might identify controls that are capable of preventing or detecting misstatements in the financial statements. The period-end financial reporting process and management's monitoring of the results of operations are potential sources of such controls.

Assessing the precision of entity-level controls

IG 19.10 The key consideration in assessing the level of precision is whether the control is designed in a manner to prevent or detect on a timely basis misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating effectively.

Factors that auditors might consider when judging the level of precision of an entity-level control include the following:

- *Purpose of the control. A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.*
- *Level of aggregation. A control that is performed at a more granular level generally is more precise than one performed at a higher level. For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.*
- *Consistency of performance. A control that is performed routinely and consistently generally is more precise than one performed sporadically.*
- *Correlation to relevant assertions. A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion.*
- *Criteria for investigation. For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.*
- *Predictability of expectations. Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts. The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.*

When forming an opinion on the effectiveness of a company's internal financial controls, the auditor should evaluate evidence obtained from all sources, including misstatements detected during the financial statement audit. Evidence regarding detected misstatements also might be relevant in assessing the level of precision of entity-level controls.

Effect of entity-level controls on testing of other controls

IG 19.11 *The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls. For example, if the*

auditor has designed an audit approach with an expectation that certain entity-level controls (e.g., controls in the control environment) will be effective and those controls are not effective, the auditor might re-evaluate the planned audit approach and decide to expand his or her audit procedures.

On the other hand, the auditor's evaluation of some entity-level controls can result in a reduction of his or her testing of other controls, such as controls over corresponding relevant assertions. The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls.

Example – Monitoring the effectiveness of other controls

IG 19.12 Scenario: A small niche software developer conducts business in India and other countries, requiring the company to maintain many bank accounts. An Accounts Officer is charged with performing bank reconciliations for the accounts according to a predetermined schedule (some of the accounts have a different closing date). Through inquiries of management, the auditor learns that the company's chief financial officer ("CFO"), who is an experienced accountant, reviews on a monthly basis, the bank reconciliations prepared by the Accounts Officer as a means to determine:

- whether reconciliations are being prepared on a timely basis,
- the nature of reconciling items identified through the process, and
- whether reconciling items are investigated and resolved on a timely basis.

Audit Approach: In this example, the purpose of the control is one of the factors that the auditor considers in assessing precision of the CFO's review. The auditor has noted that the purpose of the CFO's review is to check that the staff has performed the reconciliations as described above. Therefore, the auditor does not expect the CFO's review of the reconciliations to be sufficiently precise to detect misstatements by itself. However, the CFO's review could still influence the auditor's assessment of risk because it provides additional information about the nature and consistency of the reconciliation procedures. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, he or she could reduce the direct testing of the reconciliation controls, absent other indications of risk.

Example – Entity-level controls related to payroll processing

IG 19.13 Scenario: A manufacturer of spares and parts for the transportation market has union labor, supervisors, managers, and executives. All plants run two shifts six days a week, with each having approximately the same number of employees.

The CFO has been with the company for 10 years and thoroughly understands its business processes, including the payroll process, and reviews monthly payroll summary reports prepared by the centralised accounting function. With the company's flat organisational design and smaller size, the CFO's background with the company and his understanding of the seasons, cycles, and workflows, and close familiarity with the budget and reporting processes, the CFO quickly identifies any sign of improprieties with payroll and their underlying cause whether related to a particular project, overtime, hiring, layoffs, and so forth. The CFO investigates as needed to determine

III.658 Auditing Pronouncements

whether misstatements have occurred and whether any internal control has not operated effectively, and takes corrective action.

Based on the results of audit procedures relating to the control environment and controls over management override, the auditor observes that the CFO demonstrates integrity and a commitment to effective internal financial controls.

Audit Approach: *The auditor evaluates the effectiveness of the CFO's reviews, including the precision of those reviews. He or she inquires about the CFO's review process and obtains other evidence of the review. He or she notes that the CFO's threshold for investigating significant differences from expectations is adequate to detect misstatements that could cause the financial statements to be materially misstated. He or she selects some significant differences from expectations that were flagged by the CFO and determines that the CFO appropriately investigated the differences to determine whether the differences were caused by misstatements. Also, in considering evidence obtained throughout the audit, the auditor observes that the results of the financial statement audit procedures did not identify likely misstatements in payroll expense.*

The auditor decides that the reviews could detect misstatements related to payroll processing because the CFO's threshold for investigating significant differences from expectations is adequate. However, he or she determines that the control depends on reports produced by the company's IT system, so the CFO's review can be effective only if controls over the completeness and accuracy of those reports are effective.

After performing the tests of the relevant computer controls, the auditor concludes that the review performed by the CFO, when coupled with relevant controls over the reports, meets the control objectives for the relevant aspects of payroll processing described above.

Assessing the risk of management override and evaluating mitigating actions

IG 19.14 The risk of management override of controls exists in all organisations, but the extensive involvement of owners and/or senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls in smaller, less complex companies. Company actions to mitigate the risk of management override are important to the consideration of the effectiveness of internal financial controls.

In a combined audit of internal financial controls over financial reporting and financial statements, the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud, as he or she evaluates mitigating actions in connection with the evaluation of entity-level controls and selecting other controls to test.

Assessing the risk of management override

IG 19.15 SA 240 requires the auditor to assess the risk of material misstatement due to fraud ("fraud risk"). As part of that assessment, the auditor is directed to perform the following procedures to obtain information to be used in identifying fraud risks, which includes procedures to assess the risk of management override:

- *Conducting an engagement team discussion regarding fraud risks. This discussion includes brainstorming about how and where management could override controls to engage in or conceal fraudulent financial reporting.*
- *Making inquiries of management, the audit committee, if any, and others in the company to obtain their views about the risks of fraud and how those risks are addressed. These inquiries can provide information about the possibility of management override of controls.*
- *Considering fraud risk factors. Fraud risk factors include events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalisations that enable management to justify override of controls.*

After identifying fraud risks, the auditor should assess those risks, taking into account an evaluation of the company's programs and controls that are intended to address those risks.

Because of the characteristics of fraud, the auditor's exercise of professional skepticism is particularly important when considering the risk of material misstatement due to fraud, including the risk of management override of controls.

Evaluating mitigating controls

IG 19.16 Smaller, less complex companies can take a number of actions to address the risk of management override. The following are examples of some of the controls that might address the risk of management override:

- *Maintaining integrity and ethical values;*
- *Active oversight by the audit committee;*
- *Maintaining a whistleblower program; and*
- *Controls over certain journal entries.*

When assessing a company's anti-fraud programs and controls, the auditor should evaluate whether the company has appropriately addressed the risk of management override. Often, a combination of actions might be implemented to address the risk of management override.

Evaluating integrity and ethical values

IG 19.17 An important part of an effective control environment is sound integrity and ethical values, particularly of top management, which are communicated and practiced throughout the company. A code of conduct or ethics policy is one way that a company can communicate its policies with respect to ethical behavior. This type of control can be effective if employees are aware of the company's policies and observe the policies in practice.

Auditors should evaluate integrity and ethical values as part of the assessment of the control environment component of internal control. One approach for testing the effectiveness of the company's communications regarding integrity and ethical values is to gain an understanding of what the company believes it is communicating to employees and interview employees to

III.660 Auditing Pronouncements

determine if they are aware of the existence of the company's policies for ethical behavior and what they understand those policies to be. A discussion with employees regarding observed behaviors can assist the auditor further in understanding management's past actions and determining whether management's behavior demonstrates and enforces the principles in its code of conduct. The auditor's experience with the company can also be an important source of information about whether management demonstrates integrity and ethical values in its business practices and supports the achievement of effective internal control in its day to day activities.

Evaluating audit committee oversight

IG 19.18 An active and independent audit committee evaluates the risk of management override, including identifying areas in which management override of internal control could occur, and assesses whether those risks are appropriately addressed within the company. As part of their oversight duties, the audit committee might perform duties such as meeting with management to discuss significant accounting estimates and reviewing the reasonableness of significant assumptions and judgements. The consideration of the effectiveness of the audit committee's oversight is part of the evaluation of the control environment.

In connection with the auditor's inquiries of the audit committee, the auditor may interview audit committee members to determine their level of involvement and their activities regarding the risk of management override. For example, the auditor might read minutes of audit committee discussions on matters related to the committee's oversight or might observe some of those discussions if the auditor attends the meetings in connection with the audit. In addition, the auditor can examine evidence of the board of directors or audit committee's activities that address the risk of management override, such as monitoring of certain transactions.

Evaluating whistleblower programs

IG 19.19 A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls. A key aspect of an effective whistleblower program is the appropriateness of responses to concerns expressed by employees through the program. The audit committee may review reports of significant matters and consider the need for corrective actions.

Audit procedures relating to a whistleblower program are intended to assess whether the program is appropriately designed, implemented, monitored, and maintained. Such procedures might include inquiry of employees, inspection of communications to employees about the program, and, if tips or complaints have been received, follow-up procedures to evaluate whether remedial actions were taken as necessary.

Evaluating controls over journal entries

IG 19.20 Controls that prevent or detect unauthorised journal entries can reduce the opportunity for the quarterly and annual financial statements to be intentionally misstated. Such controls might include, among other things, restricting access to the general ledger system, requiring dual authorisations for manual entries, or performing periodic reviews of journal entries to identify unauthorised entries.

As part of obtaining an understanding of the financial reporting process, the auditor should consider how journal entries are recorded in the general ledger and whether the company has controls that would either prevent unauthorised journal entries from being made to the general ledger or directly to the financial statements or detect unauthorised entries.

Considering the effects of other evidence

IG 19.21 The auditor might identify indications of management override in other phases of the combined audit of internal financial controls over financial reporting and financial statements. For example, the auditor is required to perform procedures in response to the risk of management override, including examining journal entries for evidence of fraud, reviewing accounting estimates for bias, and evaluating the business rationale for significant, unusual transactions. Also, if the auditor performs walkthroughs during the audit of internal control, he or she could obtain information about potential management override by asking employees about their knowledge of override. Also, the auditor might identify indications of management override when evaluating the results of tests of controls or other audit procedures. If the auditor identifies indications of management override of controls, he or she should take such indications into account when evaluating the risk of override and the effectiveness of mitigating actions.

Example – Audit committee oversight

IG 19.22 **Scenario:** The audit committee of a small IT services company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The audit committee performs the following procedures to address the risk of management override: (a) reviews the reasonableness of management's assumptions and judgements used to develop significant estimates; and (b) reviews the functioning of the company's whistleblower process and related reports, and from time to time, inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others), obtaining information regarding concerns about ethics or indications of management override of internal controls.

Audit approach: In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's oversight. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.

Evaluating segregation of duties and alternative controls

IG 19.23 Segregation of duties refers to dividing incompatible functions among different people to reduce the risk that a potential material misstatement of the financial statements would occur

III.662 Auditing Pronouncements

without being prevented or detected. Assigning different people responsibility for authorising transactions, recording transactions, reconciling information, and maintaining custody of assets reduces the opportunity for any one employee to conceal errors or perpetrate fraud in the normal course of his or her duties.

When a person performs two or more incompatible duties, the effectiveness of some controls might be impaired. For example, reconciliation procedures may not effectively meet the control objectives if they are performed by someone who also has responsibilities for transaction recording or asset custody.

Smaller, less complex companies' approach to segregation of duties

IG 19.24 By their nature, smaller, less complex companies have fewer employees, which limit their opportunities to implement segregation of duties. Due to these personnel restrictions, smaller, less complex companies might approach the control objectives relevant to segregation of duties in a different manner from larger, more complex companies. Despite personnel limitations, some smaller, less complex companies might still divide incompatible functions by using the services of external parties. Other smaller, less complex companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes.

Audit strategy considerations related to segregation of duties

IG 19.25 It is generally beneficial for the auditor and the company to identify concerns related to segregation of duties early in the audit process to allow the auditor to design procedures that effectively respond to those concerns. Also, management might have already identified, as part of its risk assessment, risks relating to inadequate segregation of duties and alternative controls that respond to those risks. Where walkthroughs are performed, those procedures can help identify matters related to segregation of duties.

When management implements an alternative control or combination of controls that address the same objectives as segregation of duties, the auditor should evaluate whether the alternative control or controls effectively meet the related control objectives. The auditor's approach to evaluating those alternative control or controls depends on the control objectives, the nature of the controls, and the associated risks.

Use of external resources

IG 19.26 Some small companies use external parties to assist with some of their financial reporting-related functions. Use of external parties can also help achieve segregation of certain incompatible duties without investing in additional full-time resources.

A company might use one or more types of external-party arrangements in meeting its control objectives. Consultants, other professionals, or temporary employees can assist companies in performing some controls or other duties. For more complex or specialised portions of internal control, such as cash receipts handling, payroll processing, or securities recordkeeping, the company might use an external party to perform an entire function.

When controls over a relevant assertion depend on the use of an external party to perform a particular function, the auditor could evaluate that function in relation to the company's other

relevant controls and procedures. The audit approach used with respect to the externally performed function depends on the circumstances. For those controls that are documented or are observable by the auditor (e.g., controls performed by external professionals at the company's premises), the auditor's evaluation may be similar to what he or she could perform for the company's other controls. For some externally performed functions, the direction relating to use of service organisations may be relevant.

Management oversight and review

IG 19.27A smaller, less complex company might address some segregation of duties matters through alternative controls involving management oversight and review activities, e.g., reviewing transactions, checking reconciliations, reviewing transaction reports, or taking periodic asset counts. Many of those types of management activities could be entity-level controls.

When the auditor applies a top-down approach to select the controls to test, starting at the financial statement level and evaluating entity-level controls, the auditor might identify entity-level controls that are designed to operate at a level of precision to effectively address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.

Example – Alternative controls over inventory

IG 19.28 Scenario: A provider of office furnishings and equipment uses a locked storeroom to store certain key components. The person responsible for the components has access to both the storeroom and the related accounting records. To address the risks related to undetected loss of components, the manager responsible for purchasing performs periodic spot-checks of the components and reconciles them to the general ledger in addition to the inventory ledger. The components are also included in the company's year-end inventory count. IT access controls are implemented to prevent the person responsible for the components from entering transactions or modifying related account balances in the general ledger.

Audit approach: The auditor observes the company's year-end inventory counting process. He or she inspects documentation for some of the periodic spot-checks and the related reconciliations. For discrepancies in the counts or reconciliations inspected, he or she performs inquiries and inspects the accounting records to determine whether those items were appropriately resolved. Relevant IT access controls are evaluated in connection with the evaluation of IT general controls.

Auditing information technology controls in a less complex information technology environment

IG 19.29A company's use of information technology (IT) can have a significant effect on the audit of internal financial control. The IT environment is a consideration in the auditor's risk assessments, selection of controls to test, tests of controls, and other audit procedures. This Section discusses the auditor's evaluation of IT controls in a smaller company with a less complex IT environment. It explains how the auditor could decide which IT controls to evaluate and how the auditor could evaluate those controls. In addition, it provides an overview of the major categories of IT controls and related testing considerations for a smaller, less complex IT environment.

Characteristics of less complex IT environments

IG 19.30 In smaller companies, less complex IT environments tend to have the following characteristics:

- *Transaction processing. Data inputs can be readily compared or reconciled to system outputs. Management tends to rely primarily on manual controls over transaction processing.*
- *Software. The company typically uses off-the-shelf packaged software without programming modification. The packaged software requires relatively little user configuration to implement.*
- *Systems configurations and security administration. Computer systems tend to be centralised in a single location, and there are a limited number of interfaces between systems. Access to systems is typically managed by a limited number of personnel.*
- *End-user computing. The company is relatively more dependent on spreadsheets and other user-developed applications, which are used to initiate, authorise, record, process, and report the results of business operations, and, in many instances, perform straightforward calculations using relatively simple formulas.*

The complexity of the IT environment has a significant effect on the risks of misstatement and the controls implemented to address those risks. The auditor's approach in an environment with the preceding characteristics may be different from the approach in a more complex IT environment.

Determining the scope of the evaluation of IT controls

IG 19.31 The following matters affect the scope of the auditor's evaluation of IT controls in a smaller company with a less complex IT environment –

- *The risks, i.e., likely sources of misstatement, in the company's IT processes or systems relevant to financial reporting, and the controls that address those risks.*
- *The reports produced by IT systems that are used by the company for performing important controls over financial reporting.*
- *The automated controls that the company relies on to maintain effective internal financial controls.*

The IT controls that are important to effective internal financial controls generally relate to at least one of the preceding matters, which are discussed in more detail in the following paragraphs. IT control categories and testing procedures are discussed later in this Section.

The following types of IT-related risks that could affect the reliability of financial reporting –

- *Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;*
- *Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions or inaccurate recording of transactions;*
- *Unauthorised changes to data in master files;*

- *Unauthorised changes to systems or programs;*
- *Failure to make necessary changes to systems or programs;*
- *Inappropriate manual intervention;*
- *Potential loss of data.*

The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment. In a less complex environment, the auditor could identify many of the risks by understanding the software being used and how it is installed and used by the company. After understanding the relevant IT-related risks, the auditor should identify the controls that address those risks. These controls could include automated controls and IT-dependent controls and the IT general controls that are important to the effective operation of the selected controls. For example, even the simplest IT environments generally rely on controls that are designed to make sure that necessary software updates are appropriately installed, access controls that are designed to prevent unauthorised changes to financial data, and other controls that address potential loss of data necessary for financial statement preparation.

As the complexity of the software or environment increases, the type and number of potential IT risks increase, which could lead the auditor to devote more attention to IT controls.

IT-dependent controls

IG 19.32 Many controls that smaller, less complex companies rely on are manual controls. Some of those controls are designed to use information in reports generated by IT systems, and the effectiveness of those controls depends on the accuracy and completeness of the information in the reports. When those IT-dependent controls are selected for testing, it may also be necessary to select controls over the completeness and accuracy of the information in the reports in order to address the risk of misstatement.

Other automated controls

IG 19.33 Although smaller, less complex companies tend to rely primarily on manual controls, they could rely on certain automated controls built into the packaged software to achieve some control objectives. For example, software controls can be used to maintain segregation of duties, prevent certain data input errors, or to help make sure that certain types of transactions are properly recorded. The auditor might focus some of his or her testing on these automated controls and the IT general controls that are important to the effective operation of the automated controls.

Consideration of deficiencies in general IT controls on tests of other controls

IG 19.34 IT general controls support operation of the application controls by ensuring the proper access to, and functioning of, the company's IT systems. Deficiencies in the IT general controls may result in deficiencies in the operation of the automated or IT dependent controls. One of the factors in the auditor's evaluation of the identified deficiencies in the IT general controls is the interaction of an IT general control and the related automated or IT-dependent controls.

In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change

controls, the auditor might directly test the related automated or IT-dependent manual control, giving consideration to the risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could conclude that the automated or IT-dependent manual controls operated effectively at that point in time e.g., as of the issuer's fiscal year end. On the other hand, deficient program change controls might result in unauthorised changes to application controls, in which case the auditor could conclude that the application controls are ineffective.

Example – IT-dependent controls

IG 19.35 Scenario: A company has a small finance department. For the accounting processes that have a higher risk of misstatement, senior management performs a number of business process reviews and analyses to detect misstatements in transaction processing.

The company has a small IT department that supports a packaged financial reporting system whose software code cannot be altered by the user. Since the company uses packaged software, and there have been no changes to the system or processes in the past year, the IT general controls relevant to the audit of the internal financial controls are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors. Management uses several system-generated reports in the business performance reviews, but these reports are embedded in the application and programmed by the vendor and cannot be altered.

Audit Approach: The auditor determines that senior management personnel performing the business process reviews and analyses are not involved with incompatible functions or duties that impair their ability to detect misstatements. Based on the auditor's knowledge of the financial reporting system and understanding of the transaction flows affecting the relevant assertions, the auditor selects for testing certain process reviews and analysis and certain controls over the completeness and accuracy of the information in the reports used in management's reviews. The tests of controls could include, for example –

- *Evaluating management's review procedures including assessing whether those controls operate at an appropriate level of precision.*
- *Evaluating how the company assures itself regarding the completeness and accuracy of the information in the reports used by management in the reviews. Matters that might be relevant to this evaluation include how the company determines that –*
 - *The data included in the report are accurate and complete. This evaluation might be accomplished through testing controls over the initiation, authorisation, processing, and recording of the respective transactions that feed into the report.*
 - *The relevant computer settings established by the software user are consistent with the objectives of management's review. For example, if management's review is based on items in an exception report, the reliability of the report depends on whether the settings for reporting exceptions are appropriate.*

The auditor verifies that the code in the packaged software cannot be changed by the user. The auditor also evaluates the IT general controls that are important to the effective operation of the IT-dependent controls (such as the access controls and operations controls previously described).

Categories of IT controls

IG 19.36 The remaining paragraphs of this Section discuss major categories of IT controls and considerations for testing them in a smaller, less complex IT environment.

General IT controls

IG 19.37 IT general controls are broad controls over general IT activities, such as security and access, computer operations, and systems development and system changes.

Security and access

Security and access controls are controls over operating systems, critical applications, supporting databases, and networks that help ensure that access to applications and data is restricted to authorised personnel.

In a small, less complex IT environment, security administration is likely to be centralised, and policies and procedures might be documented informally. A small number of people or a single individual typically supports security administration and monitoring on a part-time basis. Controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data, and applications tend to be detective controls rather than preventive. Access controls tend to be monitored informally.

Tests of security and access controls could include evaluating the general system security settings and password parameters; evaluating the process for adding, deleting, and changing security access; and evaluating the access capabilities of various types of users.

Computer operations

Computer operations controls relate to day-to-day operations and help ensure that computer operational activities are performed as intended, processing errors are identified and corrected in a timely manner, and continuity of financial reporting data is maintained through effective data backup and recovery procedures.

A smaller, less complex IT environment might not have a formal operations function. There might not be formal policies regarding problem management or data storage and retention, and backup procedures tend to be initiated manually.

Tests of controls over computer operations could include evaluating the backup and recovery processes, reviewing the process of identifying and handling operational problems, and, if applicable, assessing control over job scheduling.

Systems development and system changes

Systems development and system change controls are controls over systems selection, design, implementation, and configuration changes that help ensure that new systems are appropriately developed, configured, approved, and migrated into production, and controls over changes – whether to applications, supporting databases, or operating systems – that help to ensure that those changes are properly authorised and approved, tested, and implemented. Although they might be viewed as separate categories, in less complex environments, systems development and

III.668 Auditing Pronouncements

system change procedures often are combined for ease of implementation, training, and ongoing maintenance.

A smaller, less complex IT environment typically includes a single or small number of off-the-shelf packaged applications that do not allow for modification of source code. Modifications to software are prepared by and, in some cases, implemented by, the software vendor in the form of updates or patches or via a network connection between the vendor and the organisation. Typically, a small number of individuals or a single individual (employees or consultants) support all development and production activities.

Examples of possible tests of controls over systems development and system changes include examining the processes for selecting, acquiring, and installing new software; evaluating the process for implementing software upgrades or patches; determining whether upgrades and patches are authorised and implemented on a timely basis; and assessing the process for testing new applications and updates.

Application controls

Application controls are automated or IT-dependent controls intended to help ensure that transactions are properly initiated, authorised, recorded, processed, and reported. For example, in a three-way match process, received vendor invoices are entered into the system, which matches them automatically to the purchase order and goods receipt based on the document reference numbers, price, and quantity. The system's simultaneous matching of the information within the three documents upon their entry to authorise a payment to the vendor is an automated application control.

Management's review and reconciliation of an exception report generated by the system is an example of an IT-dependent manual control. The general nature of application controls tends to be similar in most IT environments, although in less complex environments, the controls tend to be manual and detective rather than automated and preventive. The testing procedures could also be similar. In most IT environments, the auditor could focus on error correction procedures over inputting, authorising, recording, processing, and reporting of transactions when evaluating application controls. However, in less complex IT environments there might be fewer financial applications affecting relevant assertions and fewer application controls within those applications.

Regardless of the complexity of the IT environment, the audit plan for testing application controls could include a combination of inquiry, observation, document inspection, and re-performance of the controls. Efficiencies can be achieved through altering the nature, timing, and extent of testing procedures performed related to automated and IT-dependent application controls if IT general controls are designed and operating effectively. In some situations, benchmarking of certain automated controls might be an appropriate audit strategy.

End-user computing controls

End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications, and other user-based applications. These applications might be used as the basis for making journal entries or preparing

other financial statement information. End-user computing is especially prevalent in smaller, less complex companies.

End-user computing controls are controls over spreadsheets and other user developed applications that help ensure that such applications are adequately documented, secured, backed up, and reviewed regularly for process integrity. End user computing controls include general and application controls over user-developed spreadsheets and applications.

Tests of controls over end-user computing could include assessing access controls to prevent unauthorised access; testing of controls over spreadsheet formulas or logic of queries and scripts; testing of controls over the completeness and accuracy of information reported by the end-user computing applications; and reviewing the procedures for backing up the applications and data.

Considering financial reporting competencies and their effects on internal financial controls

IG 19.38 To maintain effective internal financial controls, a company needs to retain individuals who are competent in financial reporting and related oversight roles. Smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting. Also, resource limitations might prevent a smaller, less complex company from employing personnel who are familiar with the accounting required for unique, complex, or non-routine transactions or relevant changes in rules, regulations, and accounting practices.

Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals.

The following Section discusses the auditor's consideration of financial reporting competencies at a smaller, less complex company, including situations in which a smaller, less complex company enlists outside assistance in financial reporting matters.

Understanding and evaluating a company's financial reporting competencies

IG 19.39 The evaluation of competence is one aspect of evaluating the control environment and the operating effectiveness of certain controls. For example, when evaluating entity-level controls, such as risk assessment and the period-end financial reporting process, the auditor could obtain information about whether –

- Management identifies the relevant financial reporting issues on a timely basis (e.g., issues arising from new transactions or lines of business or changes to accounting standards); and
- Management has the competence to ensure that events and transactions are properly accounted for and that financial statements and related disclosures are presented in conformity with generally accepted accounting principles ("GAAP").

For recurring clients, the auditor's experience in prior audit engagements can be a source of information regarding management's financial reporting competencies. The auditor could be aware of specific accounts or disclosures that have caused problems in prior engagements, or of management's response to past changes in accounting pronouncements. These experiences can

III.670 Auditing Pronouncements

inform the auditor about management's financial reporting competencies, including whether and how management identifies and responds to financial reporting risks. The procedures performed to evaluate the period-end financial reporting process could also be valuable to the evaluation of financial reporting competency.

The auditor's inquiries and observations pertaining to the company's overall commitment to competence, which is part of the evaluation of the control environment, can also inform the auditor's assessment of financial competency. The auditor can consider whether and how the company and management –

- *Establish and agree on the knowledge, skills and abilities needed to carry out the required responsibilities prior to hiring individuals for key financial reporting positions,*
- *Train employees involved in financial reporting processes and provide them with the appropriate tools and resources to perform their responsibilities, and*
- *Periodically review and evaluate employees relative to their assigned roles, including whether the audit committee (or board of directors) evaluates the competencies of individuals in key financial reporting roles, such as the chief executive and financial reporting officers.*

Auditors may keep in mind that company financial reporting personnel do not need to be experts in all areas of accounting and financial reporting but need to be sufficiently competent with respect to the accounting for current and anticipated transactions and changes in accounting standards to identify and address the risks of misstatement.

Supplementing competencies with assistance from outside professionals

IG 19.40 Some smaller, less complex companies might not have personnel on staff with experience in certain complex accounting matters that are encountered. In these circumstances, a company might engage outside professionals to provide the necessary expertise (i.e., an individual or firm possessing special skill or knowledge in the particular accounting and financial reporting matter). When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, the auditor may consider the combined competence of company personnel and other parties that assist with functions related to financial reporting.

When an outside professional provides accounting assistance related to relevant assertions or the period-end financial reporting process, the auditor might begin by considering how the company assures itself that events and transactions are properly accounted for and that financial statements and the related disclosures are free of material misstatement. The company might have differing levels of involvement with outside professionals, depending upon the nature of the services provided. The auditor could evaluate management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks. In performing this evaluation, the auditor can consider –

- *Whether management recognises situations for which additional expertise is needed to adequately identify and address risks of misstatement.*

- *How management determines that the outside professionals possess the necessary qualifications. For example, management might obtain information from the professional about his or her skills and competence.*
- *Whom management designates to oversee the services and whether they possess the suitable skill, knowledge, or experience to sufficiently oversee the outside professionals. (Note: Management is not required to possess the expertise to perform or re-perform the services.)*
- *Whether management has established controls over the work of the outside accounting professional and over the completeness and accuracy of the information provided to the outside professional. For example, in addition to reviewing the work of the outside professional, management might inquire about the professional's monitoring and review procedures related to the work performed by the professional for the company.*
- *How management participates in matters involving judgement, for example, whether management understands and makes significant assumptions and judgements underlying accounting calculations prepared by an outside professional.*
- *How management evaluates the adequacy and the results of the services performed, including the form and content of the outside accounting professional's findings, and accepts responsibility for the results of the services.*

In gathering evidence to support this evaluation, the auditor could hold discussions with both management and the outside professional, perhaps while obtaining an understanding of the period-end financial reporting process. The auditor could also inspect documentation that provides support for management's oversight of the outside professional.

Example – Assistance from outside professionals

IG 19.41 Scenario: A small developer of analytical software products does not have an individual with strong tax accounting expertise on staff. The company retains a third party accounting firm (not its auditor) to prepare the income tax provision, including deferred tax. Management obtains information from the third-party accounting firm about the training and experience of the staff assigned to do this work. The company's CFO, who has basic knowledge of tax accounting, reviews and discusses the tax provision with the accounting firm that prepared it, and compares the provision to CFO's expectations based on past periods, budgets, and knowledge of business operations.

Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages an outside professional to provide technical assistance. Further, the auditor evaluates management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks of material misstatement regarding the income tax provision. As part of this evaluation, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the

III.672 Auditing Pronouncements

company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.

Obtaining sufficient appropriate evidence when the company has less formal documentation

IG 19.42 Implementing and assessing effective internal financial controls by a company's management generally involves some level of documentation. A smaller, less complex company often has different needs for documentation, and the nature of that documentation might differ from that of a larger or more complex organisation. Differences in the form and extent of control documentation of smaller, less complex companies generally relate to their operating characteristics, particularly to fewer resources and more direct interaction of senior management with controls.

The nature and extent of a company's documentation of internal financial controls can have a significant effect on the auditor's strategy regarding the audit of internal financial control. This Section discusses how the auditor could adapt his or her audit strategy to obtain sufficient appropriate evidence in an environment with less formal documentation.

Audit strategy considerations relating to audit evidence

IG 19.43 The auditor must plan and perform the audit to obtain evidence that is sufficient to obtain reasonable assurance about whether significant deficiencies or material weaknesses exist as of the date specified in management's assessment. The auditor can obtain this evidence through direct testing or using the work of others, as appropriate. Procedures the auditor could perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control. The nature, timing, and extent of tests of controls depend on the risk associated with the controls. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Documentation of processes and controls

IG 19.44 Larger companies with complex operations are more likely to have formal documentation of their processes and controls, such as in-depth policy manuals and systems flowcharts of processes. In a smaller, less complex company, documentation of processes and controls might take a variety of forms. For example, information about processes and controls might be found in other documentation, such as memoranda, questionnaires, software manuals, source documents, or job descriptions. This documentation might not cover every process and might not be in a consistent form across all processes.

Where walkthroughs are performed, auditors could use those procedures to obtain an understanding of the flow of transactions affecting relevant assertions and to assess the design effectiveness of certain controls, even when documentation is limited.

Documentation of operating effectiveness of controls

IG 19.45 In a smaller, less complex business, the nature and extent of documentation of the operating effectiveness of controls may vary. Also, evidence of a control's operation might exist

only for a limited period. The type and availability of evidence regarding controls to be tested can affect the auditor's testing strategy. In particular, company documentation can influence the nature and timing of audit procedures performed. For example, the nature of some audit procedures e.g., document inspection, requires documentation. Also, the timing of some tests of controls might be determined, in part, based on when the evidence of the controls' operation is available.

Obtaining sufficient evidence about the operating effectiveness of controls can be challenging when there is limited documentation of their operation. In those situations, inquiry combined with other procedures, such as observation of activities, inspection of documentation produced or used by the controls, and re-performance of certain controls, might provide sufficient evidence about whether a control is effective.

As a practical matter, the auditor also needs to obtain documentation of the work of others to use that work to reduce the auditor's own testing.

Other considerations

IG 19.46 When auditing a smaller, less complex company with limited documentation, generally it is helpful to obtain an understanding of the nature and availability of audit evidence relating to internal financial controls as early in the audit process as practical. This understanding ordinarily includes consideration of existing documentation regarding –

- Company processes and procedures, particularly for transactions affecting relevant assertions and controls that the auditor is likely to select for testing.
- Monitoring of other controls performed by management or others. The auditor can then identify gaps in important documentation so alternatives can be explored. For example, if the CFO prepares contemporaneous documentation of certain controls and retains it for a limited period, the auditor might arrange to obtain access to that documentation for testing purposes. Early conversations with management about these matters can help provide auditors with the most flexibility in developing efficient and effective audit strategies.

If the company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation. A practical way to identify such other documentation is to look at the information that the company uses to run the business.

One of the practical considerations when selecting controls to test and determining the nature, timing, and extent of testing is the nature and availability of evidence of operating effectiveness. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor could select the control for which evidence of operating effectiveness can be obtained more readily.

Example - Obtaining information about processes and controls

IG 19.47 Scenario: A small manufacturer in the electronics industry periodically makes large purchases of specialty components. The company has established procedures covering the initiation, authorisation, and recording of these purchases, although the company has not

III.674 Auditing Pronouncements

developed in-depth policies and procedures manual. The company's procedures provide for completion of a form that describes the product requirements and payment terms and indicates how to record the purchase. The forms are reviewed and approved by the CEO and CFO before the purchase is executed.

When the goods are received, they are matched with the purchase form and accounted for as indicated on the form.

Audit Approach: The auditor inspects a copy of a completed purchase form and related documentation to obtain an initial understanding of the flow of the purchase transactions. He or she follows up with inquiries of personnel involved in the process of authorising, sending, and accounting for the purchases and traces the recording of the transactions through the accounting system. He or she summarises understanding of the transaction flow in a memo and includes a copy of a purchase form in the work papers.

The auditor uses his or her understanding of the purchase process to plan and perform tests of selected controls over the purchases.

Example – Obtaining evidence about operating effectiveness of controls

IG 19.48 Scenario: One control that management relies on with respect to the period-end financial reporting process is the CFO's review of the quarterly financial statements prepared by the controller. The CFO does not create separate documentation of the review but does retain copies of the financial statements with handwritten notes and other markings for reference purposes. The review comments are sent to the controller via email, and the company's email system retains the email messages. If errors are identified, the controller prepares adjusting entries, which are approved by the CFO.

Each quarter, the CFO and controller prepare and present to the audit committee a financial package, explaining significant trends in the company's financial condition, operating results, and cash flows, as well as comparisons to budgeted amounts and comparable prior periods.

Audit Approach: The auditor can draw upon multiple sources of audit evidence to evaluate whether the control is in place and operating effectively to detect errors in the period-end financial reporting process. The auditor can make inquiries of the CFO to obtain an understanding of the frequency, nature, timing, and level of precision of the CFO's review. He or she can corroborate this understanding and evaluate the operating effectiveness of the review by, for selected items, inspecting copies of the reviewed drafts of the financial statements, reviewing comments sent to the controller, and reviewing adjusting entries and supporting information. He or she can also talk to other employees to find out if the CFO contacts them to ask questions, what types of questions are asked, and how those questions are resolved. In addition, he or she can read the information in the financial package delivered to the audit committee and might observe the CFO's financial review with the audit committee, if the auditor attends the meetings in connection with the audit.

Auditing smaller, less complex companies with pervasive control deficiencies

IG 19.49 In some audits of internal financial control, auditors might encounter companies with numerous or pervasive deficiencies in internal financial controls. Smaller, less complex companies

can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls.

Auditing internal financial controls in companies with pervasive deficiencies can be challenging. The auditor's strategy is influenced by the nature of the control deficiencies and factors such as the effect of the deficiencies on other controls and the availability of audit evidence. Although the facts and circumstances can vary significantly, the auditor might not be able to express an unqualified opinion on the effectiveness of internal financial controls in some of these situations.

Pervasive deficiencies that result in material weaknesses

IG 19.50 The auditor's objective in an audit of internal financial control is to express an opinion on the adequacy and operating effectiveness of the company's internal financial controls over financial reporting. Because a company's internal financial controls cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.

Ordinarily, the auditor's strategy should include tests of controls as necessary to support a conclusion that internal financial controls are adequate and effective. However, the auditor's existing knowledge of the company or information obtained early in the audit process might lead an auditor to a preliminary judgement that internal financial controls is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses. In those situations, the auditor's strategy for testing selected controls may depend on the effect of the pervasive deficiencies on other controls, as discussed in the following paragraphs.

Considering the effect of pervasive control deficiencies on other controls

IG 19.51 When the auditor encounters pervasive control deficiencies, he or she might decide that those deficiencies also impair the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. For example, certain deficient entity-level controls, such as the following, might impair the effectiveness of other controls over relevant assertions:

- *Ineffective control environment (considering the risk profile of the company). An ineffective control environment can increase the risk associated with a control by rendering its design ineffective or preventing it from operating effectively. Also, certain controls in the control environment, such as maintaining financial reporting competencies, might be necessary for the effective functioning of other controls.*
- *Ineffective IT controls or information systems. Ineffective information systems could impair the effectiveness of certain IT-dependent controls (e.g., monitoring controls that rely on the reports produced by an ineffective information system).*
- *Pervasive lack of segregation of duties without appropriate alternative controls. When a person performs two or more incompatible duties, the design of some controls might be ineffective without appropriate alternative controls.*

III.676 Auditing Pronouncements

- *Frequent management override of controls. A control that is frequently overridden is less likely to operate effectively. The effectiveness of controls that depend on an overridden control also might be impaired.*

The top-down audit approach can help the auditor identify pervasive control deficiencies earlier in the audit process and take them into account in determining the audit approach for testing other controls.

The auditor's preliminary judgements regarding the effect of the pervasive control deficiencies can help determine the approach to gathering audit evidence. When the pervasive control deficiencies adversely affect other controls, the auditor may modify the planned testing of the other controls because less evidence generally is needed to support a conclusion that controls are not effective than a conclusion that controls are effective. For example, if a control is likely to be impaired because of another control's deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary (e.g., if a walkthrough has not been performed) to conclude that a control is not operating effectively. Also, detected misstatements from the audit of the financial statements could indicate that a control is not effective.

Some companies might have pervasive control deficiencies and still have effective controls over some relevant assertions. For the selected controls that are likely to be effective, the auditor should test those controls to obtain the evidence necessary to support a conclusion about their operating effectiveness. The pervasive control deficiencies may affect the risk associated with the controls selected for testing, and, in turn, the amount of audit evidence needed.

Scope limitation due to lack of sufficient audit evidence

IG 19.52 Pervasive deficiencies in a company's internal financial controls do not necessarily prevent an auditor from obtaining sufficient audit evidence to express an opinion on internal financial controls. If the auditor determines that sufficient evidence is available to express an opinion, the auditor should perform tests of those controls that are important to the auditor's conclusion about the effectiveness of the company's internal financial controls and evaluate the severity of the identified control deficiencies.

In some audits of companies with pervasive control deficiencies, the auditor could become aware that there is minimal available evidence about the design and operation of internal financial controls. Such situations could lead the auditor to conclude that the lack of available evidence constitutes a scope limitation that will prevent him or her from obtaining reasonable assurance necessary to express an opinion on internal financial controls, including identification of existing material weaknesses.

The auditor may issue a report disclaiming an opinion on internal financial controls as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.

The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

The auditor's report should disclaim an opinion on internal control and disclose the substantive reasons for the disclaimer. The report should also disclose the material weaknesses of which the auditor is aware.

Even if the auditor lacks sufficient evidence to express an opinion on internal financial control, the auditor might still be able to obtain sufficient evidence to perform an audit of the financial statements. The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal financial control in assessing control risk and determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.

Example – Pervasive deficiencies and testing of controls

IG 19.53 Scenario: A small company has a two-person staff that handles all of the accounting and financial reporting duties. The staff is competent in routine financial reporting matters but has difficulty with more complex accounting matters, such as valuation of stock-based compensation and income tax calculations and disclosures.

The lack of competencies in these areas has resulted in adjustments based on the auditor's identification of material misstatements.

Audit Approach: Based on the auditor's experience with the company, he or she expects that controls over the valuation/allocation and disclosures related to stock based compensation and income taxes will not be effective. For those assertions, the auditor obtains evidence about the respective controls during a walkthrough of the related process. Also, misstatements in those assertions were detected in the financial statement audit, and he or she observes that the controls failed to prevent or detect those misstatements. Based on this evidence, auditor concludes that the controls over those assertions are not effective.

With respect to routine financial reporting processes, such as cash receipts and disbursements, the auditor plans to perform tests of the selected controls to obtain enough evidence to support a conclusion that the respective controls are effective.

Example – Lack of sufficient audit evidence

IG 19.54 Scenario: A development stage company is devoted exclusively to research and development for a new product and currently generates no revenue. The financial staff consists of a CFO and accounting clerk. The company's principal accounting records consist of a bank book and payroll records, and the company has no documentation of policies and procedures. Most of its controls are undocumented supervisory checks by the CFO.

Late in the fourth quarter, a management dispute results in the resignation of the CFO and termination of the accounting clerk. Management hires an accountant on a temporary contract basis to prepare financial statements from the company's existing records and to help the company establish appropriate controls over its financial reporting functions. However, most of these controls were implemented near or shortly after year-end.

III.678 Auditing Pronouncements

Audit Approach: As the auditor begins trying to obtain an understanding of the company's internal financial controls and evaluate entity-level controls, he or she notes that there is minimal information available about the controls that existed at year-end.

Because of the turnover in financial reporting personnel, the auditor is unable to perform inquiries, observations, or other procedures to understand the flow of transactions and related controls in significant processes. The auditor identifies some material weaknesses, but he or she determines that the lack of evidence results in a scope limitation because he or she cannot obtain reasonable assurance that all of the existing material weaknesses are identified.

Accordingly, the auditor ceases further audit procedures in the audit of internal financial control. The auditor's report on internal financial controls contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses that he or she identified.

IG 20 Reporting Considerations (Refer Paragraph 153–156 and 163)

IG 20.1 The auditor should modify the audit report on internal financial controls if any of the following conditions exist:

- a. The auditor has identified deficiencies in the design or operation of internal controls, which individually or in combination has been assessed as material weakness.
- b. There is a restriction on the scope of the engagement.

IG 20.2 A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing. Such a misstatement may occur on an annual basis (either before or after an audit), or through interim financial reporting (e.g., quarterly results, which are un-audited).

IG 20.3 In evaluating the severity of a deficiency in internal financial controls, the auditor should primarily consider two factors: the likelihood that the deficiency will result in a financial misstatement, and the magnitude of such an outcome. Thus, this process is, in essence, an exercise of risk analysis. Like the generally accepted accounting principles (GAAP) that govern the preparation of financial statements, there are no clear bright-line tests based solely on quantitative measures for assessing a deficiency or combination of deficiencies as a significant deficiency or material weakness; qualitative measures must also be considered, and professional judgement is required.

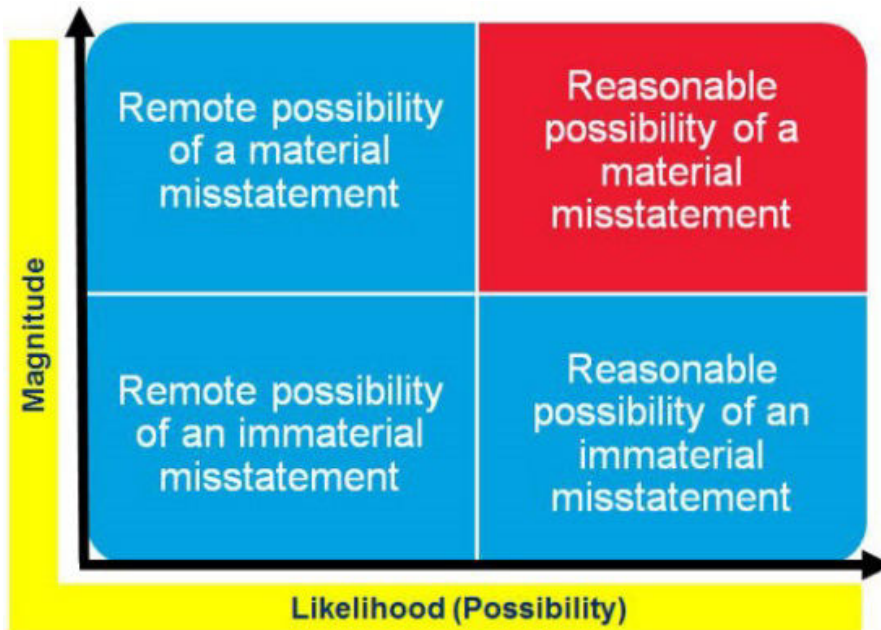


Figure: Evaluation of Deficiencies

Refer **Appendix V** for additional factors for evaluating deficiencies and examples of different categories of deficiencies.

Modified opinion on internal financial controls over financial reporting

IG 20.4 For purposes of this Guidance Note, the following terms have the meanings attributed below:

- (a) Pervasive – A term used, in the context of control deficiencies, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to the internal controls not being adequate and / or not operating effectively. Pervasive effects on the internal financial controls over financial reporting are those that, in the auditor’s judgment:
- (i) are not confined to internal controls over specific elements, accounts or items of the financial statements;
 - (ii) if so confined, represent or could represent a substantial proportion of the financial statements or impacts the audit opinion on the financial statements of the company; or
 - (iii) in relation to disclosures, are fundamental to users’ understanding of the financial statements.
- (b) Modified opinion – A qualified opinion, an adverse opinion or a disclaimer of opinion.

Circumstances When a Modification to the Auditor’s Opinion on Internal Financial Controls Over Financial Reporting Is Required

III.680 Auditing Pronouncements

IG 20.5 The auditor shall modify the opinion in the auditor's report on internal financial controls over financial reporting when:

- (a) The auditor concludes that, based on the audit evidence obtained, the internal financial controls over financial reporting is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis; or the control is missing; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the internal financial controls over financial reporting is adequate and / or operating effectively to provide reasonable assurance that it is designed, implemented or operated in such a way that it is able to prevent, or detect and correct material misstatements in the financial statements on a timely basis.

Determining the Type of Modification to the Auditor's Opinion on Internal Financial Controls Over Financial Reporting

Qualified Opinion

IG 20.6 The auditor shall express a qualified opinion on Internal Financial Controls Over Financial Reporting when the auditor, having obtained sufficient appropriate audit evidence, concludes that such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis; or the control is missing, but the effects/possible effects of the material weakness in such internal controls are material but is not pervasive to the financial statements. (Refer Scenario 1 and 3 in Example 2 of Appendix III)

Adverse Opinion

IG 20.7 The auditor shall express an adverse opinion on Internal Financial Controls Over Financial Reporting when the auditor, having obtained sufficient appropriate audit evidence, concludes that:

- (a) such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis; or the control is missing, and the effects/possible effects of the material weakness in such internal controls are both material and pervasive to the financial statements, even if the audit opinion on the financial statements is unmodified; (Refer Scenario 2 and 4 in Example 2 of Appendix III)
- (b) the system of internal financial controls over financial reporting adopted by the Company does not consider / adequately consider the essential components of internal control as stated in Section III of Part B of this Guidance Note (Refer Scenario 5 in Example 2 of Appendix III); or
- (c) the audit opinion on the financial statements is required to be modified and such modification is also consequent to the material weakness in the company's internal financial controls over financial reporting. (Refer Example 4 of Appendix III) .

IG 20.8 The qualified or adverse opinion on internal financial controls over financial reporting may relate only to the operating effectiveness of such controls or may relate to both the adequacy and operating effectiveness of such controls, based on the audit evidence obtained.

Disclaimer of Opinion

IG 20.9 The auditor shall disclaim an opinion on the company's internal financial controls over financial reporting:

- (a) if the company has not established its system of internal financial control over financial reporting considering the essential components of internal control stated in this Guidance Note (Refer Scenario 1 in Example 3 of Appendix III); or
- (b) the auditor is unable to obtain sufficient appropriate audit evidence to express an opinion on the internal financial controls over financial reporting but is able to perform appropriate substantive procedures to express an opinion on the financial statements (Refer Scenario 2 in Example 3 of Appendix III); or
- (c) when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion on the company's internal financial controls over financial reporting, and / or the auditor concludes that consequent to the material weakness in such internal controls the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. (Refer Scenario 3 in Example 3 of Appendix III)

IG 20.10 When the auditor plans to issue a modified opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report should also include –

- The definition of a material weakness as stated in this Guidance Note.
- The description of the material weakness identified in the company's internal financial controls over financial reporting. This description should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the preparation and presentation of the company's financial statements issued during the existence of the deficiency. This description should also address the requirements in paragraph 157.
- The consideration of the effect of the modified opinion on internal financial controls over financial reporting on the audit opinion on the financial statements of the company.

Effect of a modified report on internal financial controls over financial reporting on the audit of financial statements

IG 20.11 A modified report on internal financial controls over financial reporting does not in effect imply that the audit report on financial statements should also be qualified. In an audit of financial statements, the assurance obtained by the auditor is through both internal controls and substantive procedures.

III.682 Auditing Pronouncements

IG 20.12 Effect of Tests of Controls on Substantive Procedures: If, during the audit of internal financial controls, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

IG 20.13 Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal financial controls does not diminish this requirement.

IG 20.14 If, as a result of the substantive procedures, the auditor is of the opinion that sufficient reliable audit evidence has been obtained to address the risk identified or gain assurance on the account balance being tested, the auditor should not qualify the audit opinion on the financial statements.

For example, if a material weakness is identified with respect to customer acceptance, credit evaluation and establishing credit limits for customers resulting in a risk of revenue recognition where potential uncertainty exists for ultimate realisation of the sale proceeds, the auditor may modify the opinion on internal financial controls in that respect. However, in an audit of financial statements, the auditor when performing substantive procedures obtains evidence of confirmation of customer balances and also observes that all debtors as at the balance sheet date have been subsequently realised by the date of the audit, the audit opinion on the financial statements should not be qualified, though the internal control deficiency exists.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls:

IG 20.15 In an audit of internal financial controls, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal financial controls. This evaluation should include, at a minimum:

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures - The extent of such misstatements might alter the auditor's judgement about the effectiveness of controls.

IG 20.16 To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should guide the auditor's risk assessments, and in determining the testing necessary to conclude on the effectiveness of a control.

Interpretation of an unmodified report on financial statements with a modified report on internal financial controls over financial reporting

IG 20.17 When an auditor issues an unmodified opinion on the company's financial statements, this is a representation to the users of financial statements that the auditor has followed applicable auditing and related professional standards so as to allow the auditor to conclude with reasonable assurance that the financial statements are in conformity with the generally accepted accounting principles in all material respects. An unmodified audit opinion is not a guarantee of error-free financials, but is rather the conclusion by an auditor – using audit procedures and professional judgement that are reasonable to the circumstances – that the statements are fairly presented.

IG 20.18 Neither the auditor nor the company is required to disclose whether the audit process itself revealed financial statement errors that were corrected before the statements were approved. The degree to which the auditor is involved in requiring management to correct financial statements prior to their issuance is an indication of whether the company – using only its own personnel (either employees or third party consultants) – will produce financial information that is materially accurate.

IG 20.19 Whilst the auditors apply both test of controls and substantive testing to gain assurance on the financial statements, the management relies solely on its internal financial controls when preparing financial statements. The ability of a company to accurately describe its own financial condition is particularly relevant when the company discloses un-audited financial information, as in quarterly result filed with the Stock Exchanges. Thus, while the audit report of a company's financial statements may be unmodified, this provides little information to those outside the company as to whether other financial information (such as interim financial information) is of similar reliability.

Scope limitations

IG 20.20 The auditor can express an opinion on the company's internal financial controls only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the adequacy or effectiveness of internal financial controls.

IG 20.21 When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal financial controls (paragraph 157 (f), (g), and (h)); to do so might overshadow the disclaimer.

IG 20.22 If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management

and the audit committee⁶ that the audit of internal financial controls cannot be satisfactorily completed.

Impact of modified opinion on internal financial controls over financial reporting in subsequent interim period financial reporting

IG 20.23 As stated in paragraph IG 20.19, the management relies solely on its internal financial controls when preparing financial statements and as such the ability of a company to accurately describe its own financial condition is dependent on the adequacy and operating effectiveness of the internal financial controls.

IG 20.24 If the auditor's report for the audit of internal financial controls under the Act for the financial year proceeding the interim period was modified consequent to material weakness, the auditor should consider the effect of such modification when carrying out a review of interim financial statements / information under SRE 2400 or SRE 2410 issued by the Institute of Chartered Accountants of India.

IG 20.25 Accordingly, the auditor should carry out additional procedures to determine if the material weakness and the significant deficiency in the internal financial controls as reported in the previous financial year have been remediated. The auditor should consider the guidance provided for testing design of controls, testing operating effectiveness of controls and remediation testing in determining the timing, nature and extent of testing.

IG 20.26 If after performing such additional procedures as explained in paragraph IG 20.25, the auditor concludes that the significant deficiency or material weakness in internal control reported earlier has not been remediated, the auditor shall modify his or her report on the interim financial statements / information describing the material weakness reported earlier and stating that based on the procedures carried out by him or her, the said material weakness in internal control does not appear to have been remediated. If any of the significant deficiencies reported to those charged with governance in the earlier year has not been remediated and such deficiency in control is considered as a material weakness in the current period, the report of the auditor on the interim financial statements / information should describe the deficiency and state that the same is viewed as a material weakness in the current interim period.

IG 20.27 If the interim financial statements are subject to audit, the auditor should comply with the Standards on Auditing for reporting on such interim financial statements. In planning and performing the audit, the auditor should consider the effect of the significant deficiency or material weakness reported in the previous financial year on the interim financial statements. Since such audit is not carried out as per the provisions of the Act, the auditor is not required to separately test and report on the internal financial controls in the interim period.

IG 21 Understanding and Evaluating Financial Reporting Process

IG 21.1 The financial reporting process, while an undefined term in the professional standards, generally refers to the process that begins when the underlying flows of transactions at the

⁶ In case of a small or a one person company as defined in the Act, since there is no requirement to have an audit committee, the auditor would make such communication to the Board of Directors.

account/ assertion level culminate (e.g., typically in a subsidiary ledger or the general ledger). For a company, the financial reporting process encompasses the activities necessary to prepare, review, and approve the quarterly and annual financial statements, including the required disclosures, for filing in accordance with the required rules and regulations.

IG 21.2 Because of its importance to financial reporting and to the auditor's opinions on internal financial controls and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following:

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and non-recurring adjustments to the annual and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.
- With regard to the consolidated financial statements, the understanding the financial reporting process would include understanding the procedures for:
 - a) identification of subsidiaries, associates and joint ventures that would form part of the consolidation process;
 - b) identification of inter-company transactions for elimination and elimination of any unrealised profits on such transactions;
 - c) identification and quantification of minority interest;
 - d) ensuring consistency of accounting policies amongst the consolidating entities;
 - e) ensuring consistency of the classification of account balances amongst the consolidating entities;
 - f) recording recurring and non-recurring adjustments to the annual and quarterly consolidated financial statements; and
 - g) ensuring appropriate disclosures in the consolidated financial statements.
- In addition to the above, the auditor should also assess the impact, if any, of the subject matter of any qualification, adverse opinion or disclaimer stated by any of the component auditors in their respective components, and any remedial measures effected by the parent company to mitigate the effect of such observations in the component audit reports on the financial reporting process for the consolidated financial statements.

IG 21.3 As part of evaluating the period-end financial reporting process, the auditor should assess:

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;

III.686 Auditing Pronouncements

- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and eliminating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Understanding the financial reporting process

IG 21.4 The auditor is required to obtain a sufficient understanding of the processes and flows of transactions for significant accounts and disclosures to validate the points at which a material misstatement could occur, and for identifying the controls that mitigate those potential misstatements. His/her understanding of the flows of transactions and processes of the significant accounts and disclosures begins at the initiation of a transaction and concludes with its presentation in the financial statements. For practical purposes, the auditor typically bifurcate understanding of significant accounts and disclosures (including the process for consolidating and preparing the financial statements) into two parts: (1) the account/assertion level process and (2) the financial reporting process (depicted in Figure below):

- **Significant Accounts:** Separately understand the flows of transactions and processes (and related controls) for each significant account as part of the account /assertion level process until the transactions reach an appropriate "hand-off" point to the financial reporting process (e.g., a subsidiary ledger or the general ledger).
- **Disclosures:** Understand the flows of transactions and processes (and related controls) for the preparation of each disclosure as part of the financial reporting process (although the controls related to the underlying transactions and events may have already been addressed at the account/assertion level).

Note: Disclosures may alternatively be addressed in conjunction with the related significant account balance at the account/assertion level until they are accumulated at the financial reporting process level.

- **Preparation of the Financial Statements:** Understand the processes (and related controls) for the preparation, review, and approval of the financial statements as part of the financial reporting process.

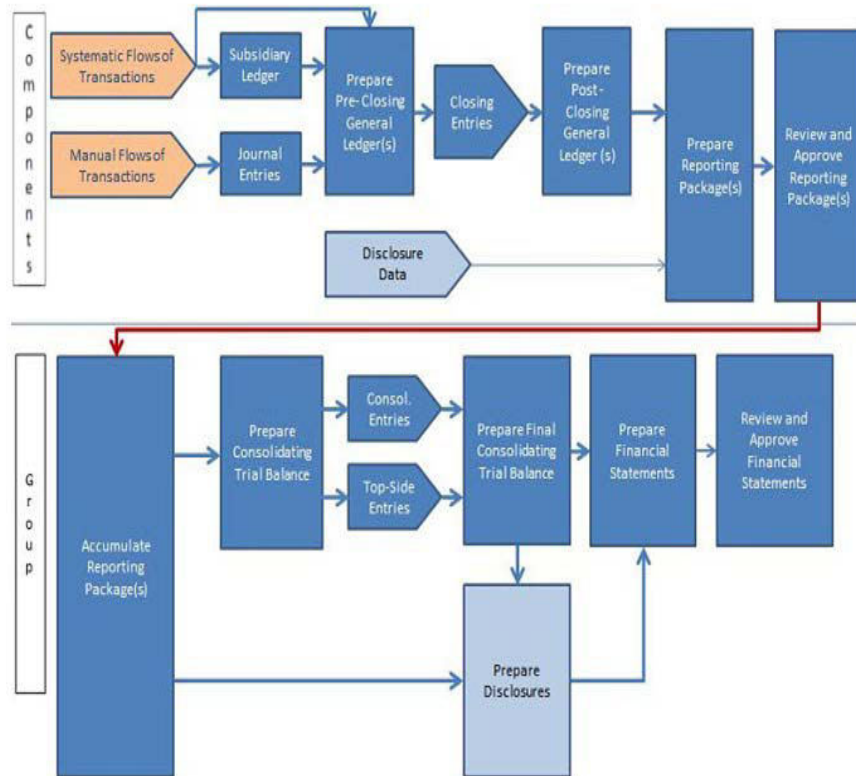


Figure: Understanding financial reporting process

IG 21.5 Similar to how the auditor obtains an understanding of the processes and relevant controls relating to individual account balances and disclosures, performing a walkthrough of the financial reporting process is likely to be the most effective way to understand the financial reporting process from beginning-to-end, and provides the basis for identifying the risks of material misstatement and the relevant controls, any relevant IPE, and any relevant application systems.

IG 21.6 Reviews and financial analysis of the draft financial statements and related disclosures by management, the disclosure committee, the audit committee, or the board of directors are important controls that support their assertion and certifications. However, while these controls may be considered “direct” controls, they are often not designed to operate at a sufficient level of precision to address a risk of material misstatement by themselves (e.g., the purpose of such a control is to identify anomalies, not verify that the amounts are fairly stated). Nonetheless, these controls are typically selected for testing, as they are important to the overall reliability of financial reporting even when they are not sufficiently precise on their own.

Understanding the application systems and controls over financial reporting process

IG 21.7 Many entities use technology to automate aspects of the financial reporting process. Identifying the relevant application systems that support the financial reporting processes is

III.688 Auditing Pronouncements

necessary to identify the IT risks and general IT controls or other controls (e.g., direct controls) that are relevant to the financial reporting process.

Considerations when identifying controls relevant to the financial reporting process may include:

- Automated interfaces: Data typically flows into the general ledger either systematically through automated interfaces or via journal entries that are manually input. When the system users rely on automated interfaces (i.e., the electronic transfer of transactions and data between systems), similar to an automated control, auditor subject the automated interface to testing. The extent of testing depends in part on whether the application is subject to effective general IT controls.
- Consolidation applications/tools: Financial reporting application systems (e.g., Hyperion) may be used to automate the consolidation process and may interface with one or more data warehouses or other application systems. Accordingly, when the system users rely on the application's automated controls, the reliability of the data, and/or the reports generated by the application systems (which are IPE), the application is relevant to ICFR and the relevant IT risks and controls (e.g., general IT or other similar controls) are identified.

For example, the entity uploads the financial data received from its branches into Hyperion in which the consolidation with head office is performed as well as the output of financial data for analysis. Hyperion (including the underlying data warehouse) is within the scope of the general IT controls; therefore, the identified IT risks are addressed by the general IT controls that operate over Hyperion.

For example, the entity uploads data from the general ledger system into a data warehouse that is not within the scope of the general IT controls. Therefore, the entity implemented controls such as manual input/output controls to verify that the data coming out of the data warehouse agrees with the data that was uploaded into the data warehouse and we test the reports (which are IPE) more extensively since the application is not subject to general IT controls.

In addition, review-type controls (e.g., a review of financial information and data by management, the disclosure committee or the board of directors) are often dependent upon the accuracy and completeness of the reporting packages and data (which are IPE) derived from these applications/tools; therefore, consideration and testing of the design and operating effectiveness of the relevant controls, including the general IT controls, may also be relevant for purposes of evaluating the effectiveness of such review-type controls.

IG 21.8 The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

- The classes of transactions in the company's operations that are significant to the financial statements;
- The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

- The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;
- How the information system captures events and conditions, other than transactions that are significant to the financial statements; and
- The period-end financial reporting process.

Understanding accounting policies

IG 21.9 The company's process and controls to select and apply its accounting principles, financial reporting policies, and related disclosures, underpin effective financial reporting. Accordingly, the auditor is required to obtain an understanding of the entity's selection and application of accounting policies and principles, including related disclosures.

The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;
- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- The methods the company uses to account for significant and unusual transactions; and
- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

For internal financial reporting purposes, the auditor considers the company's controls over the selection and application of GAAP (i.e., the company's controls over applying GAAP to new transactions or events or implementing new GAAP requirements). Implicit in this evaluation is the auditor's evaluation of the competence of those individuals responsible for the selection, development, and application of such policies and principles.

Understanding the process for recording journal entries

IG 21.10 The process for initiating, reviewing, authorizing and recording journal entries is integral to the financial reporting process. For many entities, this process may involve a combination of automated and manual procedures for transferring transactions and data from a source (e.g., sub-ledger, manual spreadsheet, analysis) to the general ledger.

Many entities utilise different journal entry types, for example:

III.690 Auditing Pronouncements

- Entries to record transaction activity
- Routine closing entries
- Non-routine closing entries
- Consolidating and eliminating entries
- Top-side entries

When such entries are subject to different processes and controls, they are evaluated and tested separately; that is, it is not appropriate to design a testing strategy on the basis of the controls being common if the characteristics of a common control are not met.

IG 21.11 In understanding and testing the relevant controls over the journal entry process, area based considerations specific to journal entries include the following:

- Segregation of duties (e.g., who prepares, reviews and posts entries)
- The review and approval process, including the purpose of the review (e.g., the level of management at which the review is performed “reasonableness” review versus a detailed review of the supporting documentation)
- Adequacy of the supporting documentation for the journal entry to enable a reviewer to determine whether the entry is appropriate
- Competence of the preparer
- Competence and authority of the reviewer.

IG 21.12 Management override of controls over journal entries is a presumed risk of fraud (and therefore a significant risk) that is addressed by controls at either the financial statement level (e.g., entity-level controls designed to address the risk of management override of controls) or the account balance level for each account. Accordingly, auditor focuses additional attention on the effectiveness of the design and the operating effectiveness of controls that mitigate such risk.

Understanding the process for disclosures

IG 21.13 The auditor identifies which disclosures are significant disclosures (and therefore included in the scope of a combined audit of internal financial controls over financial reporting and financial statements), then identify the relevant assertions for each significant disclosure. As the GAAP requirements are not applicable to immaterial items, it would be rare for a disclosure in an entity's financial statements not to be considered a significant disclosure. The relevant assertions for presentation and disclosure are as follows:

- Occurrence and rights and obligations — Disclosed events, transactions, and other matters have occurred and pertain to the entity.
- Completeness — All disclosures that should have been included in the Financial Statements have been included.
- Classification and understandability — Financial information is appropriately presented and described, and disclosures are clearly expressed.

- Accuracy and valuation — Financial and other information are disclosed fairly and at appropriate amounts.

There are two key considerations when developing the audit approach for disclosures:

- Identify the process steps (and controls) that are unique to each disclosure (i.e., when the process, risks and controls are not common).

For example, the preparation of the legal disclosure may be subject to different processes, risks and controls than the preparation of the stock compensation disclosures, in which case those relevant controls would be subject to testing separately. However, the use of a GAAP disclosure checklist is an example of a control that is performed on an overall basis (and therefore the control operates with respect to all disclosures).

- Identify which disclosures are derived from transactions or events for which auditor has already tested the relevant controls.

For example, the inventory footnote is typically derived from data within the general ledger. Since auditor has already tested the relevant controls over inventory into the general ledger, auditor only needs to test the controls over the accuracy and completeness of the presentation of the footnote in the draft financial statements for ICFR purposes.

Illustrative Engagement Letter

(Referred to in Paragraph 75)

Agreeing the terms of audit engagement for the audit of internal financial controls

The following factors need to be considered by an auditor when agreeing the terms of an audit engagement for the audit of internal financial controls. These factors are in addition to those stated in SA 210 "Agreeing the terms of Audit Engagements" for an audit of the financial statements.

1. In order to establish whether the preconditions for an audit of internal financial controls are present, the auditor shall:

- (a) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (i) For laying down internal financial controls to be followed by the company;
 - (ii) For ensuring that such internal financial controls are adequate and are operating effectively; (this is in addition to the requirement in Paragraphs A15 to A18 of SA 210;
 - (iii) To provide the auditor with:
 - Access to all information, such as records and documentation, and other matters that are relevant to their assessment of internal financial controls;
 - Additional information that the auditor may request from management for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Determining the acceptability of the internal financial controls criteria

2. Factors that are relevant to the auditor's determination of the acceptability of the internal financial controls criteria include:

- a) Whether the aforesaid controls are based on the essential components of internal controls as stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India.
- b) The nature of the entity (for example, whether it is a business enterprise, or not for profit organization);

- c) The size of the entity (for example, internal controls in a smaller entity are comparatively lesser than that of a large entity);
- d) Whether the entity is listed or unlisted; and
- e) Whether law or regulation prescribes any requirement for internal financial controls.

Limitation on scope prior to audit engagement acceptance

3. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the internal financial controls, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Agreement on audit engagement terms

4. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (a) The objective and scope of the audit of the internal financial controls;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable criteria to be applied for establishing the internal financial controls; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Form and content of the audit engagement letter

5. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter may be based on SA 210. The auditor may issue a combined engagement letter for reporting on financial statements and reporting on internal financial controls or a separate engagement letter for each. In addition to including the matters required by SA 210, an audit engagement letter may make reference to, for example:

- The agreement of management's responsibilities for establishing and maintaining adequate and effective internal financial controls based on the control criteria [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India".] for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

III.694 Auditing Pronouncements

- The agreement of management to make available to the auditor their evaluation and assessment of the adequacy and effectiveness of the company's internal financial controls, based on the control criteria as mentioned above.
- The agreement of management to inform the auditor of any communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.
- The agreement of providing management's conclusion over the company's internal financial controls based on the control criteria set above as of the balance sheet date;
- The agreement of providing the component auditors' report under section 143(3)(i) in the case of components that are companies covered under the Companies Act, 2013 that form part of the consolidated financial statements of the parent company

Example of a Separate Audit Engagement Letter for Audit of Internal financial controls over financial reporting

The following is an example of an engagement letter for an audit of internal financial controls over financial reporting in the case of standalone financial statements that is separate from the engagement letter for an audit of the financial statements prepared in accordance with the Accounting Standards notified under Section 133 of the Companies Act, 2013. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 210. It will need to be varied according to individual requirements and circumstances.

To the Board of Directors of ABC Company Limited:

The objective and scope of the audit

You have requested that I / we carry out an audit of the internal financial controls over financial reporting of ABC Company Limited (the 'Company') as at March 31, 20X1 [balance sheet date] in conjunction with our audit of the standalone and consolidated financial statements of the Company for the year ended on that date.

I am/We are pleased to confirm my / our acceptance and my / our understanding of the audit engagement by means of this letter. My / Our audits will be conducted with the objective of expressing our opinion under Section 143(3)(i) of the Companies Act, 2013 ("2013 Act") on the adequacy of the internal financial controls system over financial reporting and the operating effectiveness of such controls as at March 31, 20X1 based on the internal control *criteria* established by you.

Audit of internal financial controls over financial reporting

I / We will conduct our audit of the internal financial controls over financial reporting in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ("the

Guidance Note”) and the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, to the extent applicable to an audit of internal financial controls over financial reporting. These Guidance Note and Standards require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness as at the balance sheet date.

An audit of internal financial controls over financial reporting involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness.

The procedures selected depend on the auditor’s judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

Inherent limitations in an audit of internal financial controls over financial reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management’s responsibility

My / Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

- (a) For establishing and maintaining adequate and effective internal financial controls based on [state criteria] [for example, “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”] for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Act.
- (b) To provide me / us with:
 - (i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is

III.696 Auditing Pronouncements

relevant to the preparation of the financial statements such as records, documentation and other matters;

- (ii) All information, such as records and documentation, and other matters that are relevant to my / our assessment of internal financial controls;
 - (iii) Management's evaluation and assessment of the adequacy and effectiveness of the company's internal financial controls, based on the control criteria [mention the control criteria] and all deficiencies, significant deficiencies and material weaknesses in the design or operations of internal financial controls identified as part of management's evaluation.
 - (iv) Additional information that I / we may request from [management] for the purpose of the audit.
 - (v) Unrestricted access to persons within the entity from whom I / we determine it necessary to obtain audit evidence. This includes my / our entitlement to require from the officers of the Company such information and explanations as I / we may think necessary for the performance of my / our duties as auditor.
 - (vi) Any communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.
 - (vii) Management's conclusion over the company's internal financial controls based on the control criteria set above as at the balance sheet date [insert date].
 - (viii) Informing me / us of significant changes in the design or operation of the Company's internal financial controls that occurred during or subsequent to the date being reported on, including proposed changes being considered.
 - (ix) Providing me / us with the component auditors' report under section 143(3)(i) in the case of components that are companies covered under the Companies Act for the purposes of our reporting in the case of the consolidated financial statements of the Company.
- (c) As part of my / our audit process, I / we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to me / us in connection with the audit.

I / We also wish to invite your attention to the fact that my / our audit process is subject to 'peer review' / 'quality review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of my / our working papers during the course of the peer review.

Reporting

My / Our audit report will be issued pursuant to the requirements of Section 143(3)(i) of the Act. The form and content of my / our report may need to be amended in the light of my / our audit findings.

Our opinion on the adequacy and operating effectiveness of internal financial controls over financial reporting in the case of the consolidated financial statements of the Company, in so far as it relates to subsidiary companies, jointly controlled companies and associate companies incorporated in India, will be based solely on the reports of the auditors of such companies.

[Insert any other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Any other relevant information]

This letter should be read in conjunction with my / our letter dated ___ for the audit of the standalone and consolidated financial statements of the Company under the Act.

I / We look forward to full cooperation from your staff during my / our audits.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for my / our audit of the internal financial controls over financial reporting including our respective responsibilities.

(Signature)

XYZ & Co.

Chartered Accountants

Place:

Date:

Acknowledged on behalf of ABC Company Limited by

.....

(Signature)

Name and Designation

Date

Appendix II

Illustrative Management Representation Letter for Matters Relating to Audit of internal financial controls over financial reporting

(Referred to in paragraphs 150 - 152)

The following illustrative letter includes written representations that are required by this Guidance Note and SA 580 “Written Representations” and other Standards on Auditing as applicable to an audit of internal financial controls over financial reporting, which are in effect as at _____ [balance sheet date]. It is assumed in this illustration that the relevant internal financial controls are based on the essential components of internal control identified in the Guidance Note on Audit of Internal Financial Controls over Financial Reporting, issued by the Institute of Chartered Accountants of India; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the internal financial controls over financial reporting in the audit of ABC Company Limited (“the Company”) in conjunction with your audit of the standalone/ consolidated financial statements of the Company for the year ended March 31, 20X1, for the purpose of expressing an opinion as to whether the Company had, in all material respects, an adequate internal financial controls system over financial reporting and the operating effectiveness of such controls in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (“the Guidance Note”) and the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, to the extent applicable to an audit of internal financial controls over financial reporting.

We confirm that to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves:

1. We are responsible for establishing and maintaining adequate and effective internal financial controls based on [mention control criteria] and the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated [insert date] and, in particular, the assertions to you on the internal financial controls in accordance with the _____ [for example, “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”].

2. We have performed an evaluation and made an assessment of the adequacy and effectiveness of the company’s internal financial controls and based on the following control criteria [mention the control criteria].

3. We have not used the procedures performed by you during the audit of internal financial controls over financial reporting as part of the basis for our assessment of the effectiveness of internal financial controls.
4. Based on the assessment carried out by us and the evaluation of the results of the assessment, we conclude that the Company has adequate internal financial controls system that was operating effectively as at the March 31, 20X1 [balance sheet date] (or) Except for the below mentioned deficiencies noted during our assessment and evaluation of internal financial controls, the other relevant controls were determined adequate and were operating effectively as at March 31, 20X1 [balance sheet date].
 - a. (brief of design deficiencies)
 - b. (brief of deficiencies in operating effectiveness)
5. We have disclosed to you all deficiencies in the design or operation of internal financial controls identified as part of management's evaluation, including separately disclosing to you all such deficiencies that we believe to be significant deficiencies or material weaknesses in internal financial controls in paragraph [4].
6. There were no instances of fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal financial controls. (or) The following instances of fraud that resulted in material misstatement of financial statements in earlier years and frauds involving senior management or management or other employees who have a significant role in the company's internal financial controls were noted: (list instances and amounts involved).
7. The control deficiencies identified in the previous engagement of audit of internal financial controls and communicated to the Company and those charged with governance have been remediated, except for the following: (list control deficiencies not remediated as at the balance sheet date) (This issue is not applicable in the first year when the Company is subject to an audit of internal financial controls under the Companies Act, 2013)
8. There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.
9. We have provided you with:
 - All information, such as records and documentation, and other matters that are relevant to your assessment of internal financial controls;
 - Additional information that you have requested from us; and
 - Unrestricted access to those within the entity.
 - Audit reports of the component auditors, including their report under Section 143(3)(i) of the Act for the following subsidiary companies, jointly controlled companies and associate companies to whom reporting under Section 143(3)(i) is applicable:

III.700 Auditing Pronouncements

- There are no other subsidiary companies, jointly controlled companies and associate companies of the company to whom reporting under Section 143(3)(i) is applicable and whose auditors have not issued their report under Section 143(3)(i) of the Act.
- In the case of the following subsidiary companies, jointly controlled companies and associate companies of the company to whom reporting under Section 143(3)(i) is applicable, the respective component's year end is other than that of the Company:

With respect to these components, we have provided to you the audit reports of the component auditors, including their report under Section 143(3)(i) of the Act for their respective financial year under the Act that has been considered in the preparation of the consolidated financial statements of the Company.

10. There are no changes in the internal financial controls system from March 31, 20X1 [balance sheet date] till the date of this representation letter. (or) The following changes have been made to the internal financial controls system since March 31, 20X1 [balance sheet date] and the date of this letter: (list changes and reason for the change).

11. These changes include corrective actions taken by us with regard to significant deficiencies or material weaknesses noted with respect to the following: (list significant deficiency or the material weakness and the related change in internal controls).

12. The following changes to internal financial controls system have been proposed as on date of this representation letter but have not yet been implemented: (list proposed changes and reason for the proposed change).

13. The changes to the internal financial controls since March 31, 20X1 [balance sheet date] and the proposed changes that are under consideration by the Company do not impact our assessment, evaluation and conclusion of the internal financial controls system as at March 31, 20X1 [balance sheet date]

14. [Any other matters that the auditor may consider appropriate.]

For and on behalf of ABC Company Limited

.....

(Signature)

Name and Designation

.....

(Signature)

Name and Designation

APPENDIX III

Illustrative Reports on Internal Financial Controls Over Financial Reporting

(Referred to in paragraphs 157 - 164)

Example 1 – Separate Reports

The following is an **example of separate unmodified audit report for an audit of internal financial controls over financial reporting in the case of standalone financial statements**. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 “Forming an Opinion and Reporting on financial Statements”. The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

ANNEXURE TO THE INDEPENDENT AUDITOR’S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 (“the Act”)

I / We have audited the internal financial controls over financial reporting of ABC Company Limited (“the Company”) as of March 31, 20X1 in conjunction with my / our audit of the standalone financial statements of the Company for the year ended on that date.

Management’s Responsibility for Internal Financial Controls

The Company’s management is responsible for establishing and maintaining internal financial controls based on _____ [for example, “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”.] These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditors’ Responsibility

My / Our responsibility is to express an opinion on the Company’s internal financial controls over financial reporting based on my / our audit. I / We conducted my / our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the “Guidance

III.702 Auditing Pronouncements

Note”) and the Standards on Auditing, issued by ICAI and deemed to be prescribed under section 143(10) of the Companies Act, 2013, to the extent applicable to an audit of internal financial controls, both applicable to an audit of Internal Financial Controls and, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance Note require that I/we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

My/Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. My/Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. The procedures selected depend on the auditor’s judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

I / We believe that the audit evidence I/we have obtained is sufficient and appropriate to provide a basis for my /our audit opinion on the Company’s internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

In my / our opinion, the Company has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at March 31, 20X1, based on _____ [for example, “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”].

For XYZ & ASSOCIATES

Chartered Accountants

(Firm’s Registration No. _____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Example 2 – Separate Reports

The following is an example of separate modified (qualified / adverse) audit report for an audit of internal financial controls over financial reporting and not impacting the audit opinion on the standalone financial statements of the company. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 “Forming an Opinion and Reporting on Financial Statements”. The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 ("the Act")

I / We have audited the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20X1 in conjunction with my / our audit of the standalone financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

The Company's management is responsible for establishing and maintaining internal financial controls based on _____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"]. These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditors' Responsibility

My / Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on my/our audit. I/We conducted our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") and the Standards on Auditing, to the extent applicable to an audit of internal financial controls, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance Note require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

My / Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. My / Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

I / We believe that the audit evidence I / we have obtained is sufficient and appropriate to provide a basis for my / our qualified / adverse audit opinion on the Company's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Scenario 1 - Qualified Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting

Qualified opinion

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:

- a) The Company did not have an appropriate internal control system for customer acceptance, credit evaluation and establishing customer credit limits for sales, which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.
- b) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, except for the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has maintained, in all material respects, adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were operating effectively as of March 31, 20X1, based on _____ [for example "the internal control over financial reporting criteria established by the

III.706 Auditing Pronouncements

Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”].

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 standalone financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the standalone financial statements of the Company.

Scenario 2 - Adverse Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting

Adverse opinion

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:

- a) The Company did not have an appropriate internal control system for customer acceptance, credit evaluation and establishing customer credit limits for sales, which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.
- b) The Company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification. Further, the internal control system for identification and allocation of overheads to inventory was also not adequate. These could potentially result in material misstatements in the Company’s trade payables, consumption, inventory and expense account balances.
- c) list other deficiencies identified]

A ‘material weakness’ is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were not operating effectively as of March 31, 20X1, based on _____ [for example “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”].

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 standalone financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the financial statements of the Company.

Scenario 3 - Qualified Opinion on operating effectiveness of Internal Financial Controls Over Financial Reporting and unmodified opinion on adequacy of such controls

Qualified opinion

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified in the operating effectiveness of the Company's internal financial controls over financial reporting as at March 31, 20X1:

- a) The Company's internal financial controls over customer acceptance, credit evaluation and establishing customer credit limits for sales, were not operating effectively which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.
- b) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, the Company has, in all material respects, maintained adequate internal financial controls over financial reporting as of March 31, 20X1, based on _____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"], and except for the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company's internal financial controls over financial reporting were operating effectively as of March 31, 20X1.

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the standalone financial statements of the Company.

Scenario 4 - Adverse Opinion on operating effectiveness of Internal Financial Controls Over Financial Reporting and unmodified opinion on adequacy of such controls

Adverse opinion

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified in the operating effectiveness of the Company's internal financial controls over financial reporting as at March 31, 20X1:

- a) The Company's internal control system for customer acceptance, credit evaluation and establishing customer credit limits for sales, were not operating effectively which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

III.708 Auditing Pronouncements

- b) The Company's internal control system for inventory with regard to receipts, issue for production and physical verification were not operating effectively. Further, the internal control system for identification and allocation of overheads to inventory was also not operating effectively. These could potentially result in material misstatements in the Company's trade payables, consumption, inventory and expense account balances.
- c) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, the Company has, in all material respects, maintained adequate internal financial controls over financial reporting as of March 31, 20X1, based on _____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"], and because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company's internal financial controls over financial reporting were not operating effectively as of March 31, 20X1.

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 standalone financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the financial statements of the Company.

Scenario 5 - Adverse Opinion on Internal Financial Controls Over Financial Reporting – essential components of internal controls not adequately considered in the internal financial controls established by the company

Adverse opinion

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:

- a) The Company did not have an appropriate internal financial control system over financial reporting since the internal controls adopted by the Company did not adequately consider risk assessment, which is one of the essential components of internal control, with regard to the potential for fraud when performing risk assessment,
- b) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained

adequate and effective internal financial controls over financial reporting as of March 31, 20X1, based on _____ [for example, “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”].

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 standalone financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the standalone financial statements of the Company.

For XYZ & ASSOCIATES
Chartered Accountants
(Firm’s Registration No. _____)

Signature
(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)

Place:

Date:

Example 3 – Separate Reports

The following is an example of separate modified (disclaimer) audit report for an audit of internal financial controls over financial reporting with / without impact on audit opinion on the standalone financial statements. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 “Forming an Opinion and Reporting on Financial Statements”. The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 ("the Act")

I / We were engaged to audit the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20X1 in conjunction with my / our audit of the financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

The Company's management is responsible for establishing and maintaining internal financial controls based on [.....for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"]. These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditors' Responsibility

My / Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on my/our audit conducted in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") and the Standards on Auditing, to the extent applicable to an audit of internal financial controls, both issued by the Institute of Chartered Accountants of India.

Because of the matter described in Disclaimer of Opinion paragraph below, I / we was / were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on internal financial controls system over financial reporting of the Company.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors

of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Disclaimer of Opinion

Scenario 1 – Framework for internal financial control over financial reporting not established but does not impact the audit opinion on financial statements

According to the information and explanation given to us, the Company has not established its internal financial control over financial reporting on criteria based on or considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India. Because of this reason, we are unable to obtain sufficient appropriate audit evidence to provide a basis for my / our opinion whether the Company had adequate internal financial controls over financial reporting and whether such internal financial controls were operating effectively as at March 31, 20X1.

I / We have considered the disclaimer reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the standalone financial statements of the Company, and the disclaimer does not affect my / our opinion on the standalone financial statements of the Company.

Scenario 2 – Auditor unable to obtain sufficient appropriate audit evidence on internal financial controls over financial reporting but does not impact audit opinion on the financial statements

The system of internal financial controls over financial reporting with regard to one of the significant branches of the Company at _____ were not made available to me / us to enable me / us to determine if the Company has established adequate internal financial control over financial reporting at the aforesaid branch and whether such internal financial controls were operating effectively as at March 31, 20X1.

I / We have considered the disclaimer reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the financial statements of the Company, and the disclaimer does not affect my / our opinion on the financial statements of the Company.

Scenario 3 – Auditor unable to obtain sufficient appropriate audit evidence on internal financial controls over financial reporting and impacting audit opinion on the financial statements

The system of internal financial controls over financial reporting with regard to the Company were not made available to me / us to enable me / us to determine if the Company has established adequate internal financial control over financial reporting and whether such internal financial controls were operating effectively as at March 31, 20X1.

I / We have considered the disclaimer reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the standalone financial statements of the Company, and

III.712 Auditing Pronouncements

the disclaimer has affected my / our opinion on the financial statements of the standalone Company and I / we have issued a qualified (/ adverse / disclaimer of) opinion on the financial statements.

For XYZ & ASSOCIATES
Chartered Accountants
(Firm Registration No. _____)

Signature
(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)

Place:

Date:

Example 4 – Separate Reports

The following is an example of separate modified (adverse) audit report for an audit of internal financial controls over financial reporting causing a modified report on the standalone financial statements. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 “Forming an Opinion and Reporting on Financial Statements”. The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

ANNEXURE TO THE INDEPENDENT AUDITOR’S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 (“the Act”)

I / We have audited the internal financial controls over financial reporting of ABC Company Limited (“the Company”) as of March 31, 20X1 in conjunction with my / our audit of the financial statements of the Company for the year ended on that date

Management’s Responsibility for Internal Financial Controls

The Company’s management is responsible for establishing and maintaining internal financial controls based on ____ [for example “the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India”]. These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and

errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditors' Responsibility

My / Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on my/our audit. I/We conducted our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") and the Standards on Auditing, to the extent applicable to an audit of internal financial controls, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance Note require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

My / Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. My / Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

I / We believe that the audit evidence I / we have obtained is sufficient and appropriate to provide a basis for my / our adverse audit opinion on the Company's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the

III.714 Auditing Pronouncements

internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Adverse Opinion

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:

- (a) The Company did not have appropriate internal controls for reconciliation of physically inventory with the inventory records, which has resulted in misstatement of inventory values in the books of account.
- (b) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, because of the effect of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained adequate and effective internal financial controls over financial reporting as of March 31, 20X1, based on _____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India".

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 standalone financial statements of the Company, and the / these material weakness/es has / have affected my / our opinion on the standalone financial statements of the Company and I / we have issued a qualified (/ adverse / disclaimer of) opinion on the standalone financial statements.

For XYZ & ASSOCIATES
Chartered Accountants
(Firm Registration No. _____)

Signature
(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)

Place:

Date:

Example 5 – Separate Report in case of Consolidated Financial Statements

Note:

The following illustrative format is based on the assumptions that

- The Group has:
 - Certain components which have been audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the consolidated financial statements of the Group. The auditors of such components which are Indian companies, have submitted report on section 143(3)(i) of the Companies Act, 2013.
 - Certain components which are unaudited and such component/s is/ are not material to the consolidated financial statements of the Group.
- The independent auditor of Consolidated Financial Statements
 - Gives a clean opinion in respect of section 143(3)(i) of the Companies Act, 2013
 - Discloses the aforementioned facts about the Components in the “Other Matters” Paragraph in accordance with the Announcement issued by the Auditing and Assurance Standards Board under the authority of the Council of ICAI in February 2014.

Illustrative Report on Internal Financial Controls Over Financial Reporting in the case of Consolidated financial statements

(Referred to in paragraphs 157 - 164)

The following is an **example of unmodified audit report for an audit of internal financial controls over financial reporting in the case of consolidated financial statements**. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 “Forming an Opinion and Reporting on financial Statements”. The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

ANNEXURE TO THE INDEPENDENT AUDITOR’S REPORT OF EVEN DATE ON THE CONSOLIDATED FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 (“the Act”)

In conjunction with my / our audit of the consolidated financial statements of the Company as of and for the year ended March 31, 20X1, I / We have audited the internal financial controls over financial reporting of ABC Company Limited (hereinafter referred to as “the Holding Company”) and

III.716 Auditing Pronouncements

its subsidiary companies, its associate companies and jointly controlled companies, which are companies incorporated in India, as of that date.

Management's Responsibility for Internal Financial Controls

The respective Board of Directors of the of the Holding company, its subsidiary companies, its associate companies and jointly controlled companies, which are companies incorporated in India, are responsible for establishing and maintaining internal financial controls based on _____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India (ICAI)].] These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to the respective company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditor's Responsibility

My / Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on my / our audit. I / We conducted my / our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") issued by the ICAI and the Standards on Auditing, issued by ICAI and deemed to be prescribed under section 143(10) of the Companies Act, 2013, to the extent applicable to an audit of internal financial controls, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance Note require that I/we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

My / Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. My / Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

I / We believe that the audit evidence I / we have obtained and the audit evidence obtained by the other auditors in terms of their reports referred to in the Other Matters paragraph below, is

sufficient and appropriate to provide a basis for my /our audit opinion on the Company's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

In my / our opinion, the Holding Company, its subsidiary companies, its associate companies and jointly controlled companies, which are companies incorporated in India, have, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at March 31, 20X1, based on _____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"].

Other Matters

Our aforesaid reports under Section 143(3)(i) of the Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting insofar as it relates to ___(number) subsidiary companies, ___(number) associate companies and ___(number) jointly

III.718 Auditing Pronouncements

controlled companies, which are companies incorporated in India, is based on the corresponding reports of the auditors of such companies incorporated in India.

For XYZ & ASSOCIATES

Chartered Accountants

(Firm's Registration No. _____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Appendix IV*

Illustrative Risks of Material Misstatement, Related Control Objectives and Control Activities

(Referred to in paragraphs 77 and 100)

Standard on Auditing (SA) 315 requires understanding of the entity in order to identify and respond to the risks of material misstatement in the financial statements. In doing so, auditors focus their risk-assessment process on the classes of transactions; account balances, including transaction types within account balances; and disclosures that are material and, thus, have a reasonable possibility of containing a misstatement that, individually or when aggregated with others, has a material effect on the financial statements. The determination of whether a class of transactions, account balance, or disclosure is material is a matter of professional judgment that takes into account quantitative and qualitative factors and is made without regard to the effectiveness of controls.

Once the material classes of transactions, account balances, and disclosures [significant accounts and disclosures] are identified, one needs to identify and assess the risks of material misstatement at the financial-statement level and the assertion level for those classes of transactions, account balances, and disclosures. Following the identification of risks of material misstatement, one has to identify relevant controls that may address the risks of material misstatement that are responsive to the risks of material misstatement and the related assertion.

This appendix has been developed to provide guidance and examples to assist in identifying risks of material misstatement at the assertion level and relevant controls that may address the applicable risks of material misstatement.

For each class of transactions and account balance, risks of material misstatement and relevant controls are divided into two categories: “Core Risks and Controls,” which may be applicable for normal risks of material misstatement on most entities, and “Other Possible Risks and Controls,” which may or may not be applicable.

The risks of material misstatement included in this appendix are illustrative only and are intended to provide examples of common risks. As a result, the risks of material misstatement are described using generic terminology. It is critical that users identify the risks of material misstatement that are relevant to the entity based on professional judgment and not rely solely on the risks of material misstatement provided in this appendix. Additionally, when the risk of material misstatement is considered significant, further tailoring or complete customisation is often appropriate.

The Example Controls included in this appendix are illustrative only and are intended to provide examples of controls that may address the relevant risks of material misstatement. Actual controls in place at the entity that address the relevant risks of material misstatement may and often do differ; thus, the Example Controls may (1) require some degree of tailoring to describe the control more specifically or (2) be replaced entirely by a control in place at the entity that addresses the risk of material misstatement. Users who use this appendix should not interpret the existence of

* The complete Appendix IV is given in CD along with this Guidance Note.

III.720 Auditing Pronouncements

more than one Example Control to indicate that all controls would need to be tested to address the risk of material misstatement. It is critical that practitioners identify the actual controls in place at the entity that address the risks of material misstatement and not rely solely on the Example Controls provided in this appendix.

This appendix will assist in the identification of relevant controls that may address the applicable risks of material misstatement. This includes specific application or general IT controls.

This appendix also illustrates the risk of material misstatement and the control related to the risk that is likely to be reflected in the Other Affected Accounts.

Material classes of transactions or account balances relevant to the entity may not be included in this appendix. Therefore, it is critical that users identify the relevant transaction types for each material class of transaction, account balance, and disclosure for the specific circumstances of the entity.

Certain example controls illustrated in this appendix may use computer-generated information as source data. Users should consider the controls related to this computer-generated information and tailor the control description accordingly.

Certain example controls involve an application control. Users should identify specific controls at the entity related to application controls and tailor the control description accordingly.

Certain reports relevant to example controls may be electronically generated by an ERP system. If such reports are generated from an ERP system, users should consider the controls related to this computer-generated information and tailor the control description accordingly.

Illustrative list of Risks of Material Misstatement - Control Objectives - Control Activities and illustrative work paper templates for testing controls have been provided in a CD along with this Guidance Note for the following account balances and processes:

1. Cash/Bank Balances
2. Prepaid Expenses
3. Trade Receivables
4. Inventory
5. Fixed Assets
6. Goodwill and Intangible Assets
7. Trade payables
8. Provision for expenses
9. Loans/Borrowings
10. Employee Benefits
11. Income Taxes
12. Deferred Taxes
13. Provision for Income taxes/Advance Income taxes

14. Share Capital
15. Revenue from Operations
16. Cost of Sales
17. Depreciation/ Amortisation and Other Expenses
18. Finance Cost
19. Journal Entries
20. Financial Reporting

Examples of Control Deficiencies

(Referred to in paragraph IG 20)

(Depending on severity could also be significant deficiencies and material weaknesses)

Examples of Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Examples of Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy, for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

Examples of Significant Deficiencies

Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.
- Antifraud programs and controls.
- Controls over non-routine and non-systematic transactions.

III.724 Auditing Pronouncements

- Controls over the period end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and non-recurring adjustments to the financial statements.

Examples of Material Weaknesses

Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement. (The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control.
- This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.
- Identification of fraud of any magnitude on the part of senior management. (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud. However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude including fraud resulting in immaterial misstatements on the part of senior management, of which he or she is aware.)

- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

(Referred to in Paragraph IG 14)

Standard on Internal Audit (SIA) 5 - Sampling*

Contents

	Paragraph(s)
Introduction.....	1-2
Definitions.....	3-9
Use of Sampling in Risk Assessment Procedures and Tests of Controls	10-12
Design of the Sample.....	13-19
Sample Size	20-21
Statistical and Non-Statistical Approaches	22-26
Selection of the Sample	27-28
Evaluation of Sample Results	29-38
Documentation	39
Effective Date	40
Examples of Factors Influencing Sample Size for Tests of Controls	
Examples of Factors Influencing Sample Size for Tests of Details (TOD)	
Methods of Sample Selection	
Frequency of Control Activity and Sample Size	

The following is the text of the Standard on Internal Audit (SIA) 5, Sampling, issued by the Council of the Institute of Chartered Accountants of India. These Standards should be read in conjunction with the Preface to the Standards on Internal Audit, issued by the Institute.

In terms of the decision of the Council of the Institute of Chartered Accountants of India taken at its 260th meeting held in June 2006, the following Standard on Internal Audit shall be recommendatory in nature in the initial period. The Standards shall become mandatory from such date as notified by the Council.

* Published in the October 2008 issue of The Chartered Accountant.

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards on the design and selection of an audit sample and provide guidance on the use of audit sampling in internal audit engagements.

The SIA also deals with the evaluation of the sample results. This SIA applies equally to both statistical and non-statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence.

2. When using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of the internal audit engagement unless otherwise specified by the client.

Definitions

3. "Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the internal auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form a conclusion concerning the population. Certain testing procedures, however, do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying internal audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

4. "Error" means either control deviations when performing tests of controls, or misstatements, when performing tests of details.

5. "Population" means the entire set of data from which the sample is selected and about which the internal auditor wishes to draw conclusions. A population may be divided into various strata, or subpopulations, with each stratum being examined separately.

6. "Sampling risk" means the risk that from the possibility that the internal auditor's conclusions, based on examination of a sample may be different from the conclusion reached if the entire population was subjected to the same types of internal audit procedure. The two types of sampling risk are –

(a) The risk that the internal auditor concludes, in the case of tests of controls (TOC), that controls are more effective than they actually are, or in the case of tests of details (TOD), that a material error or misstatement does not exist when in fact it does.

III.728 Auditing Pronouncements

- (b) The risk that the internal auditor concludes, in the case of tests of controls (TOC), that controls are less effective than they actually are, or in the case of tests of details (TOD), that a material error or misstatement exists when in fact it does not.

The mathematical complements of these risks are termed confidence levels.

7. "Sampling unit" means the individual items or units constituting a population, for example, credit entries in bank statements, sales invoices or debtors' balances.
8. "Statistical sampling" means any approach to sampling procedure which has the following characteristics –
- (a) Random selection of a sample; and
- (b) Use of theory of probability to evaluate sample results, including measurement of sampling risk.
9. "Tolerable error" means the maximum error in a population that the internal auditor is willing to accept.

Use of Sampling in Risk Assessment Procedures and Tests of Controls

10. The internal auditor performs risk assessment procedures to obtain an understanding of the entity, business and its environment, including the mechanism of its internal control. Ordinarily, risk assessment procedures do not involve the use of sampling. However, there are cases, where the internal auditor often plans and performs tests of controls concurrently with obtaining an understanding of the design of controls and examining whether they have been implemented.

11. Tests of controls are performed when the internal auditor's risk assessment includes an expectation of the operating effectiveness of controls. Sampling of tests of controls is appropriate when application of the control leaves audit evidence of performance (for example, initials of the credit manager on a sales invoice indicating formal credit approval).

12. Sampling risk can be reduced by increasing sample size for both tests of controls and tests of details. Non-sampling risk can be reduced by proper engagement planning, supervision, monitoring and review.

Design of the Sample

13. **When designing an audit sample, the internal auditor should consider the specific audit objectives, the population from which the internal auditor wishes to sample, and the sample size.**

Internal Audit Objectives

14. The internal auditor would first consider the specific audit objectives to be achieved and the internal audit procedures which are likely to best achieve those objectives. In addition, when internal audit sampling is appropriate, consideration of the nature of the audit evidence sought and

possible error conditions or other characteristics relating to that audit evidence will assist the internal auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of controls over an entity's purchasing procedures, the internal auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved.

On the other hand, when performing substantive procedures on invoices processed during the period, the internal auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the periodic financial statements. When performing tests of controls, the internal auditor makes an assessment of the rate of error the internal auditor expects to find in the population to be tested. This assessment is on the basis of the internal auditor's understanding of the design of the relevant controls, and whether they have actually been implemented or the examination of a small number of items from the population.

Population

15. The population is the entire set of data from which the internal auditor wishes to sample in order to reach a conclusion. The internal auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. For example, if the internal auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

16. The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. For example, if the internal auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The internal auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

17. It is important for the internal auditor to ensure that the population is appropriate to the objective of the internal audit procedure, which will include consideration of the direction of testing. The population also needs to be complete, which means that if the internal auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period.

18. When performing the audit sampling, the internal auditor performs internal audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate.

Stratification

19. To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value). The strata need to be explicitly defined so that each sampling unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification, therefore, enables the internal auditor to direct audit efforts towards the items which, for example, contain the greatest potential monetary error. For example, the internal auditor may direct attention to larger value items for accounts receivable to detect overstated material misstatements. In addition, stratification may result in a smaller sample size.

Sample Size

20. **When determining the sample size, the internal auditor should consider sampling risk, the tolerable error, and the expected error.** The lower the risk that the internal auditor is willing to accept, the greater the sample size needs to be. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2 to the Standard.

21. The sample size can be determined by the application of a statistically based formula or through exercise of professional judgment applied objectively to the circumstances of the particular internal audit engagement.

Statistical and Non-Statistical Approaches

22. The decision of using either statistical or non-statistical sampling approach is a matter for the internal auditor's professional judgment. In the case of tests of controls, the internal auditor's analysis of the nature and cause of errors will often be of more importance than the statistical analysis of the mere presence or absence of errors. In such case, non-statistical sampling approach may be preferred.

23. When applying statistical sampling, sample size may be ascertained using either probability theory or professional judgment. Sample size is a function of several factors. Appendices 1 and 2 discuss some of these factors.

Tolerable Error

24. Tolerable error is the maximum error in the population that the internal auditor would be willing to accept and still conclude that the result from the sample has achieved the objective(s) of the internal audit.

Tolerable error is considered during the planning stage and, for substantive procedures, is related to the internal auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

25. In tests of controls, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the internal auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the internal auditor would be willing to accept so that when the results of all audit procedures are considered, the internal auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

26. If the internal auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the internal auditor would consider such matters as error levels identified in previous internal audits, changes in the entity's procedures, and evidence available from other procedures.

Selection of the Sample

27. **The internal auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.**

28. While there are a number of selection methods, three methods commonly used are:

- a. Random selection and use of CAATs
- b. Systematic selection
- c. Haphazard selection

Appendix 3 to the Standard discusses these methods.

Evaluation of Sample Results

29. **Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the internal auditor should:**

- (a) **analyse the nature and cause of any errors detected in the sample;**
- (b) **project the errors found in the sample to the population;**
- (c) **reassess the sampling risk; and**
- (d) **consider their possible effect on the particular internal audit objective and on other areas of the internal audit engagement.**

30. **The internal auditor should evaluate the sample results to determine whether the assessment of the relevant characteristics of the population is confirmed or whether it needs to be revised.**

Analysis of Errors in the Sample

31. In analysing the errors detected in the sample, the internal auditor will first need to determine that an item in question is in fact an error. In designing the sample, the internal auditor will have defined those conditions that constitute an error by reference to the audit objectives.

For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be inappropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

32. When the expected audit evidence regarding a specific sample item cannot be obtained, the internal auditor may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive account receivable confirmation has been requested and no reply was received, the internal auditor may be able to obtain sufficient appropriate audit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the internal auditor does not, or is unable to, perform satisfactory alternative procedures, or if the procedures performed do not enable the internal auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

33. The internal auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

34. In analysing the errors discovered, the internal auditor may observe that many have a common feature, for example, type of transaction, location, product line, or period of time. In such circumstances, the internal auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The internal auditor would then perform a separate analysis based on the items examined for each sub-population.

Projection of Errors

35. The internal auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the internal auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

36. For tests of controls, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

Reassessing Sampling Risk

37. The internal auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the internal auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the internal auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative internal audit procedures.

38. If the evaluation of sample results indicate that the assessment of the relevant characteristic of the population needs to be revised, the internal auditor, may:

- (a) Request management to investigate the identified errors and the potential for any further errors, and to make necessary adjustments, in cases where management prescribes the sample size; and / or
- (b) Modify the nature, timing and extent of internal audit procedures. In case of tests of controls, the internal auditor might extend the sample size, test an alternative control or modify related substantive procedures; and / or
- (c) Consider the effect on the Internal Audit Report.

Documentation

39. Documentation provides the essential support to the opinion and/ or findings of the internal auditor. In the context of sampling, the internal auditor's documentation may include aspects such as:

- i. Relationship between the design of the sample vis-à-vis specific audit objectives, population from which sample is drawn and the sample size.
- ii. Assessment of the expected rate of error in the population to be tested vis-à-vis auditor's understanding of the design of the relevant controls
- iii. Assessment of the sampling risk and the tolerable error.
- iv. Assessment of the nature and cause of errors.
- v. Rationale for using a particular sampling technique and results thereof.
- vi. Analysis of the nature and cause of any errors detected in the sample.
- vii. Projection of the errors found in the sample to the population.
- viii. Reassessment of sampling risk, where appropriate.
- ix. Effect of the sample results on the internal audit's objective(s).
- x. Projection of sample results to the characteristics of the population.

Appendix 1 to SIA 5 – Sampling

Examples of Factors Influencing Sample Size for Tests of Controls

The following are some factors which the internal auditor considers when determining the sample size required for tests of controls (TOC). These factors need to be considered together assuming the internal auditor does not modify the nature or timing of TOC or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor to be considered by Internal Auditor	Effect on sample size
An increase in the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls	Increase
An increase in the rate of deviation from the prescribed control activity that the internal auditor is willing to accept	Decrease
An increase in the rate of deviation from the prescribed control activity that the internal auditor expects to find in the population	Increase
An increase in the internal auditor's required confidence level	Increase
An increase in the number of sampling units in the population	Negligible effect

Notes –

1. Other things being equal, the more the internal auditor relies on the operating effectiveness of controls in risk assessment, the greater is the extent of the internal auditor's tests of controls, and hence the sample size is increased.
2. The lower the rate of deviation that the internal auditor is willing to accept, the larger the sample size needs to be.
3. The higher the rate of deviation that the internal auditor expects, the larger the sample size needs to be so as to make a reasonable estimate of the actual rate of deviation.
4. The higher the degree of confidence that the internal auditor requires that the results of the sample are indicative of the actual incidence of errors in the population, the larger the sample size needs to be.
5. For large populations, the actual population size has little effect on sample size. For small populations, sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 2 to SIA 5 - Sampling**Examples of Factors Influencing Sample Size for Tests of Details (TOD)**

The following are some factors which the internal auditor considers when determining the sample size required for tests of details (TOD). These factors need to be considered together assuming the internal auditor does not modify the nature or timing of TOD or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor to be considered by Internal Auditor	Effect on sample size
An increase in the internal auditor's assessment of the risk of material misstatement	Increase
An increase in the use of other substantive procedures by the internal auditor, directed at the same assertion	Decrease
An increase in the total error that the internal auditor is willing to accept (Tolerable Error)	Decrease
Stratification of the population when appropriate	Decrease
An increase in the amount of error which the internal auditor expects to find in the Population	Increase
An increase in the internal auditor's required confidence level	Increase
The number of sampling units in the population	Negligible effect

Appendix 3 to SIA 5 - Sampling

Methods of Sample Selection

The principal methods of sample selection are as –

1. **Using a computerised random number generator** or through random number tables.
2. **Systematic selection** – In this method, the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 20, and having thus determined a starting point within the first 20, each 20th sampling unit thereafter is selected. Although the starting point may be haphazardly determined, the sample is likely to be truly random if the same is determined by using a computerised random number generator or random number tables. In this method, the internal auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with any particular pattern within the population.
3. **Haphazard selection** – In this method, the internal auditor selects the sample without following any structured technique. **The internal auditor should attempt to ensure that all items within the population have a chance of selection, without having any conscious bias or predictability.** This method is not appropriate when using statistical sampling technique.
4. **Block selection** – This method involves selection of a block(s) of adjacent or contiguous items from within the population. Block selection normally cannot be used in internal audit sampling because most populations are structured in such a manner that items forming a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. This method would not be an appropriate sample selection technique when the internal auditor intends to draw valid inferences about the entire population, based on the sample.

Appendix 4 to SIA 5 - Sampling**Frequency of Control Activity and Sample Size**

The following guidance related to the frequency of the performance of control may be considered when planning the extent of tests of operating effectiveness of manual controls for which control deviations are not expected to be found. The internal auditor may determine the appropriate number of control occurrences to test based on the following minimum sample size for the frequency of the control activity dependant on whether assessment has been made on a lower or higher risk of failure of the control.

Frequency of control activity	Minimum sample size Risk of failure	
	Lower	Higher
Annual	1	1
Quarterly (including period- end, i.e., +1)	1+1	1+1
Monthly	2	3
Weekly	5	8
Daily	15	25
Recurring manual control (multiple times per day)	25	40

Note: Although +1 is used to indicate that the period–end control is tested, this does not mean that for more frequent control operations the year-end operation cannot be tested.

Guidance Note on the Companies (Auditor's Report) Order, 2016

Introduction

1. The Central Government, in exercise of the powers conferred, under sub-section (11) of section 143 of the Companies Act, 2013* (hereinafter referred to as "the Act"), issued the Companies (Auditor's Report) Order, 2016, (CARO, 2016/ "the Order") *vide* Order No. S.O. 1228(E) dated 29th March, 2016. CARO, 2016 contains certain matters on which the auditors of companies (except of those categories of companies which are specifically exempted under the Order) have to make a statement in their audit report. The text of the CARO, 2016 is given in **Appendix I** to this Guidance Note.

2. This Order is in supersession of the earlier Order issued in 2015, viz., the Companies (Auditor's Report) Order, 2015 (CARO 2015). **Appendix II** to this Guidance Note contains a clause-by-clause comparison of the reporting requirements of the Order and the erstwhile CARO 2015.

3. The purpose of this Guidance Note is to enable the members to comply with the reporting requirements of the Order. It should, however, be noted that the clarifications and explanations contained in this Guidance Note are not intended to be exhaustive and the auditors should exercise their professional judgment and experience on various matters on which they are required to report under the Order.

General Provisions Regarding Auditor's Report

4. The requirements of the Order are supplemental to the existing provisions of section 143 of the Act regarding the auditor's report. In this regard the following points may be noted:

- (i) the provisions of sub-sections (1), (2) & (3) of section 143 are applicable to all companies while the Order exempts certain categories of companies from its application; and
- (ii) the provisions of sub-section (1) require the auditor to make certain specific enquiries during the course of his audit. The auditor is, however, not required to report on any of the matters specified in the sub-section unless he has any special comments to make on the said matters. In other words, if he is satisfied with the results of his enquiries, he has no further duty to report that he is so satisfied. The Order, on the other hand, requires a statement on each of the matters specified

*Readers' attention is invited to the fact that the Companies (Amendment) Bill 2016 is before the Parliament for approval. This Guidance Note does not take into account the amendments to the Companies Act, 2013 as proposed in the aforesaid Bill.

therein, as applicable to the company.

5. Another question that arises is about the status of the Order *vis a vis* the directions given by the Comptroller and Auditor General of India under section 143(5) of the Act. In this regard, it may be noted that the Order is supplemental to the directions given by the Comptroller and Auditor General of India under section 143(5) in respect of government companies. These directions continue to be in force. Therefore, in respect of government companies, the matters specified in the Order will form part of the auditor's report submitted to the members and the replies to the aforesaid questionnaire issued by the Comptroller and Auditor General of India will be governed by the requirements of section 143(5) of the Act.

6. The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein.

Applicability of the Order

Companies Covered by the Order

7. The Order applies to all companies except certain categories of companies specifically exempted from the application of the Order.

8. The Order also applies to foreign companies as defined in clause (42) of section 2 of the Act. According to the aforesaid section, a "foreign company" means:

"Any company or body corporate incorporated outside India which -

- (a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and
- (b) conducts any business activity in India in any other manner."

9. In the case of a foreign company, wherever under any of the provisions of the Act, an audit under Chapter X of the Act is required to be carried out, the Order would be applicable.

10. The Order is also applicable to the audits of branch(es) of a company since sub-section 8 of section 143 of the Act read with Rule 12 of the Companies (Audit and Auditors) Rules, 2014 clearly specifies that a branch auditor has the same duties in respect of audit as the company's auditor. It is, therefore, necessary that the report submitted by the branch auditor contains a statement on all the matters specified in the Order, as applicable to the company, except where the company is exempt from the applicability of the Order, to enable the company's auditor to consider the same while complying with the provisions of the Order.

Companies Not Covered by the Order

11. The Order provides that it shall not apply to:
- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
 - (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
 - (iii) a company licensed to operate under section 8 of the Act;
 - (iv) a One person Company as defined under clause (62) of section 2 of the Act and a Small Company as defined under clause (85) of the section 2 of the Act; and
 - (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid-up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Schedule III to the Act, (including revenue from discontinuing operations) exceeding rupees ten crores during the financial year as per the financial statements.

12. The Order specifically exempts banking companies, insurance companies and companies which have been licensed to operate under section 8 of the Act. The Order also exempts One Person Company and a Small Company from its application. The applicability of the Order would be based on the status of the company as at the balance sheet date. It may also be noted that in case a company is covered under the definition of small company, it will remain exempted from the applicability of the Order even if it falls under any of the criteria specified for private company.

13. The specific exemption under the Order is given to companies licensed under section 8 of the Act. However, it would appear that in view of the provisions of section 465 of the Act, the exemption would also extend to companies licensed to operate under section 25 of the Companies Act 1956.

14. A private limited company, in order to be exempt from the applicability of the Order, must satisfy all the conditions mentioned above collectively. In other words, even if one of the conditions is not satisfied, a private limited company's auditor has to report on the matters specified in the Order.

Private Limited Company

15. The term "private limited company", as used in the Order, should be construed to mean a company registered as a "private company" (as defined in sub-section (68) of

section 2 of the Act}.

Paid-up Capital and Reserves and Surplus

16. Sub-section (64) of section 2 of the Act defines the term “paid-up capital” as such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid up in respect of shares issued and also includes any amount credited as paid up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called.

The Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term “paid-up share capital” as, “that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise”. Paid-up share capital would include both equity share capital as well as the preference share capital. While calculating the paid-up capital, amount of calls unpaid should be deducted from and the amount originally paid-up on forfeited shares should be added to the figure of paid-up capital. Share application money received should not be considered as part of the paid-up capital.

The Guidance Note on Terms Used in Financial Statements defines the term “reserve” as, “The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by management for a general or specific purpose other than provision for depreciation or diminution in the value of assets or for a known liability.

17. As per schedule III of Companies Act 2013 “Reserves & Surplus” consists of:-

- Capital Reserves;
- Capital Redemption Reserve;
- Securities Premium Reserve;
- Debenture Redemption Reserve;
- Revaluation Reserve;
- Share Options Outstanding Account;
- Other Reserves—(specify the nature and purpose of each reserve and the amount in respect thereof);
- Surplus i.e., balance in Statement of Profit and Loss

(Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head “Surplus”.)

Reserves are primarily of two types—capital reserves and revenue reserves. According to the Guidance Note on Terms Used in Financial Statements, the term “capital reserve”

III.742 Auditing Pronouncements

means “a reserve of a corporate enterprise which is not available for distribution as dividend”. The said Guidance Note defines the term “revenue reserve” as “any reserve other than capital reserve”. For determining the applicability of the Order to a private limited company, both capital as well as revenue reserves should be taken into consideration while computing the limit of rupees one crore; prescribed for paid-up capital and reserves & surplus. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. In case of debit balance of profit and loss, the same shall be netted for computing reserves & surplus. To summarise, total of reserves and surplus as disclosed in the financial statements should be considered in evaluating the threshold.

Borrowings

18. Borrowings from banks or financial institutions can be long term or short term and are normally in the form of term loans, demand loans, export credits, cash credits, overdraft facilities, bills purchased or discounted. Outstanding balances of such borrowings should be considered as borrowing outstanding for the purpose of computing the limit of rupees one crore. Non-fund based credit facilities, to the extent such facilities have devolved and have been converted into fund-based credit facilities, should also be considered as outstanding borrowings. The figures of outstanding borrowing would also include the amount of bank guarantees issued by the company where such guarantee(s) has (have) been invoked and encashed or where, say, a letter of credit has been devolved on the company. In case of term loans, interest accrued and due is considered as a borrowing whereas interest accrued but not due is not considered as a borrowing. Further, in case the company enjoys a facility, say, a cash credit facility, whose balance is fluctuating in nature, the Order would apply to the company in case on any day during the financial year concerned, the amount outstanding in the cash credit facility exceeds Rs. one crore as per books of the company along with other borrowings. The condition laid down in the Order is that the private company does not have total borrowing exceeding rupees one crore from any bank or financial institution at any point of time during the financial year. There is no stipulation in the Order that the borrowing should be a long-term borrowing or a short-term borrowing or that it should be a secured borrowing or an unsecured borrowing. Further, the condition would also apply notwithstanding the fact that the company has been granted an overdraft facility against, say, fixed deposits, of the company with the concerned bank. Current maturity of long term borrowings will also form part of borrowings. Moreover, outstanding dues in respect of credit cards would also be considered while calculating the limit of Rs. one crore; in respect of borrowings outstanding from a bank or financial institution. It is clarified that since the words used by the Order are ‘any bank or financial institution’, the limit of “exceeding one crore rupees” would apply in aggregate to all borrowings and not with reference to each

bank or financial institution.

Financial Institution

19. Sub section (39) of section 2 of the Act defines the term “financial institution” to include a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934 (2 of 1934)”. The term financial institution has been defined under clause (c) of Section 45I of the RBI Act 1934 as under:-

“45I (c) “financial institution” means any **non-banking institution** which carries on as its business or part of its business any of the following activities, namely:–

- (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;
- (ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;
- (iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972;
- (iv) the carrying on of any class of insurance business;
- (v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;
- (vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person, [but does not include any institution, which carries on as its principal business;
 - (a) agricultural operations; or
 - (aa) industrial activity; or]
 - (b) the purchase or sale of any goods (other than securities) or the providing of any services; or
 - (c) the purchase, construction or sale of immovable property, so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

III.744 Auditing Pronouncements

Explanation.– For the purposes of this clause, “industrial activity” means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964;

Further “non-banking institution” has been defined under clause (e) of Section 45I of RBI Act 1934 as under:-

45I (e) “non-banking institution” means a company, corporation (cooperative society).

Further, the term “financial institution” is also referred to in the context of the definition of a non-banking financial company as defined by the RBI Act, 1934. The term “non-banking financial company” has been defined under clause (f) of Section 45I of RBI Act 1934 as under:-

“45I (f) “non-banking financial company” means–

- (i) a financial institution which is a company;
- (ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- (iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;”

Accordingly the term “financial institution” shall also cover a non-banking financial company (NBFC). A list of financial institutions covered under the Companies (Acceptance of Deposits) Rules, 2014 is given in **Appendix III** to this Guidance Note. Further, private banks or foreign banks are banking institutions under the Banking Regulation Act, 1949. Therefore, loans taken from a private bank or a foreign bank would also be taken into consideration while examining the applicability of the Order.

Revenue

20. The term, “revenue”, has been defined by the Order as total revenue disclosed in Schedule III of the Act. Accordingly, the total revenue would include other income as per Schedule III. Here revenue will also include revenue from discontinuing operations as specified in the Order.

Auditor's Report to Contain Matters Specified in Paragraphs 3 and 4 of the Order

21. Every report made by the auditor under section 143 of the Act on the accounts of every company audited by him, to which this Order applies, for the financial year

commencing on or after 1st April 2015 shall, in addition, contain the matters specified in paragraphs 3 and 4 of the Order **as may be applicable**. Accordingly, the reporting under this Order shall be applicable for the financial year 2015-16 and onwards. In case the auditor has to report on the financial statements for the financial year prior to 2015-16, then the relevant earlier Order shall be applicable.

Here it is pertinent to mention that the Order specify the applicability of the matters by the words “as may be applicable”, reporting on the matters specified in paragraph 3 and 4 of the Order are to be made only on those matters which are applicable to the Company.

Non-applicability to the Consolidated Financial Statements

The Order specifically provides that it shall not apply to the auditor’s report on consolidated financial statements.

Period of Compliance

22. A question might arise as to the period in relation to which the auditor should comment or report upon the matters specified in the Order. For example, several of the questions relate to the maintenance of proper records. What should be the position of the auditor when records were improperly maintained for some part of the financial year but have been properly maintained at the balance sheet date? One view of the matter would be that no adverse report is necessary since the deficiencies existing during the year have been rectified before the auditor makes his report. However, this view does not recognise the fact that maintenance of records is not an end by itself but is a necessary condition for the auditor to satisfy himself regarding the authenticity of the transactions on which he is reporting. The better view, therefore, is to consider that the auditor is reporting on the state of affairs as they existed during the accounting year and compliance with the requirements of the Order should be judged with reference to the whole accounting year and not merely with reference to the position existing at the balance sheet date or the date at which he makes his report. However, in deciding whether or not to make an unfavourable comment, the auditor should consider what detrimental effect, if any, has been caused by the failure to comply with the requirements of the Order for any part of the year. For example, if records for fixed assets were not properly maintained for some part of the year but were properly maintained at the balance sheet date and physical verification was made after the records were properly maintained, there is no detrimental effect on the company. However, if internal control with respect to the items specified in the relevant clause of the Order was inadequate during a part of the year, some detrimental effect on the company could have occurred.

At the same time, the auditor cannot ignore the position existing at the balance sheet date or at the time at which he makes his report. The auditor might consider, in the light of the

III.746 Auditing Pronouncements

circumstances and provided he is able to satisfy himself regarding the facts, as to whether a reference to the state of affairs existing at the balance sheet date or at the date when he makes his report would be necessary to give a more complete picture to the members to whom he is reporting.

It is not necessary that the auditor should refer individually to each of the transactions throughout the year where there has not been compliance with the requirements of the Order unless the non-compliance is so significant as to merit individual attention. Normally, it should be sufficient if he indicates in general terms whether or not the requirements have been complied with.

General Approach

23. In formulating a general approach to the requirements of the Order, it is necessary to take a view regarding the objective behind the issuance of the Order. The Order does not replace an audit by an investigation in respect of the matters specified therein. Many of these matters, in any case, are covered by an auditor in the normal course of his audit and the emphasis of the Order is not, therefore, on requiring the auditor to carry out an investigation but on requiring him to give specific information on certain aspects of his work.

24. The reporting under the Order, issued under section 143(11) of the Act, is only supplemental to the audit of financial statements of the company and the auditor's report issued in terms of section 143(2) and 143(3) of the Act. Reporting under the Order should not, therefore, be construed as a separate reporting engagement. Section 143(9) of the Act, casts a duty on the auditor to comply with the auditing standards specified under section 143(10) of the Act. Hence, it should be noted that the auditor's procedures for reporting on the Order would, as in the case of audit of financial statements, need to be within the framework of the principles enunciated in the aforementioned Standards on Auditing.

25. It is possible that for the purposes of the Order, the auditor needs greater information from the management and, therefore, closer interaction with the management becomes necessary. This will ensure that there is sufficient advance planning regarding the manner in which the examination necessary for reporting on matters specified in the Order would be carried out by the auditor and the form in which the company should maintain its records so that they provide the necessary information and evidence to the auditor. An example of this would be the documents and records to be maintained by the company to provide the requisite evidence to the auditor regarding verification of fixed assets or inventories. It is, therefore, suggested that the auditor should intimate to the management, in writing, his requirements before the commencement of each audit. The auditor should also consider intimating additional requirements, if any, during the course of the audit. The auditor should also consider obtaining management representations, on

matters on which the Order requires the auditor to make a statement on certain aspects.

26. For a number of reasons, the necessity for preserving working papers by the auditors assumes greater importance in the context of the requirements of the Order. Firstly, there should be evidence that the opinion expressed by the auditor is based on an examination made by him. Secondly, there should be evidence to show that in arriving at his opinion, the auditor has given due cognisance to the information and explanations given by the company and that his opinion is not arbitrary. Thirdly, there should be evidence to show that the information and explanations obtained were full and complete, that is, the auditor has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary to be considered before arriving at his opinion. Finally, there should be evidence to show that the auditor did not merely rely upon the information or explanations given by the company but that he subjected such information and explanations to reasonable tests to verify their accuracy and completeness.

27. As the auditor needs to comply with the requirements of Standard on Auditing (SA) 230, "Audit Documentation", the auditor may take the following steps to ensure that he has adequate working papers to support the conclusions drawn in his report:

- (a) submit to the company, a questionnaire on all important matters covered by the Order.
- (b) make specific inquiries in writing on all important matters not covered by the questionnaire.
- (c) insist that replies of the company are furnished in writing and are signed by a responsible officer of the company.
- (d) where the explanations are not already separately recorded, maintain a record of the discussions with the management.
- (e) prepare his own "check-list" in respect of the requirements of the Order and record the names of the members of his staff who made the examination and the name of the company's staff who provided the information. An illustrative check-list in respect of the requirements of the Order is given in **Appendix IV** to this Guidance Note.

28. Where a requirement of the Order is not complied with but the auditor decides not to make an adverse comment, in view of the immateriality of the item, he should record rationale for the same in his working papers.

29. The mere fact that the Order is confined to certain specific matters should not be

III.748 Auditing Pronouncements

interpreted to imply that the auditor's duties in respect of other matters normally covered in the course of an audit of the financial statements are, in any way, limited or abridged by the Order. At the same time, it should be recognised that the reporting obligations under the Order are confined to the specific items stated in the Order.

30. Many of the matters covered by the Order require exercise of judgement by the auditor rather than the application of a purely objective test. For example, the auditor is required to state whether any material discrepancy noticed on physical verification of fixed assets have been properly dealt with in the accounts. This requires the exercise of judgement—firstly, in determining whether the discrepancies are material, and secondly, in deciding whether the accounting treatment is proper.

31. It may be noted that while reporting on matters specified in the Order, the auditor should consider the **materiality**, in accordance with the principles enunciated in Standard on Auditing (SA) 320(Revised), *Materiality in Planning and Performing an Audit*. The auditor obtains reasonable assurance by obtaining audit evidences to reduce audit risk to an acceptable low level. Materiality and audit risk are considered throughout the audit, in particular, when determining the nature, timing and extent of further audit procedures to be performed. For example, the auditor, in case of loans granted by the company, as referred to in Clause 3(iii) of the Order, while reporting, on the repayment schedule of various loans granted, the auditor examines the loan documentation of all large loans and conducts a test check examination of the rest, having regard to the materiality.

32. It is necessary to remember that the exercise of judgement is bound to be a somewhat subjective matter. This is, in fact, recognised by the provisions of the Act which require the expression of an opinion by the auditor. When a professional expresses an opinion, he does not guarantee that his opinion is infallible nor does he hold out that his opinion will invariably agree with the opinion of another professional on the same facts. The test of an auditor's liability in a matter which involves the exercise of judgement is not whether his opinion coincides with that of another person or authority, but whether he has expressed his opinion in good faith and after the exercise of reasonable care and skill. No liability can attach to an auditor in a matter involving the expression of an opinion based on the exercise of judgement, merely because there is a difference of opinion between him and some other person or authority or merely because some other person or authority comes to the conclusion that in expressing the opinion the auditor committed an error of judgement. The auditor may be liable, however, if it is found that he has expressed his opinion without exercising reasonable care and skill, or without applying his mind to the facts, or if he has expressed his opinion recklessly, in complete disregard of the facts.

Matters to be Included in the Auditor's Report

33. The matters to be included in the auditor's report are specified in paragraph 3 of the Order. It has sixteen clauses in all. The Clause-wise Comments are given below:-

34. Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets; [Paragraph 3(i)(a)]

Relevant Provisions

- (a) The clause requires the auditor to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets. Accounting Standard (AS) 10¹, "Accounting for Fixed Assets" defines "Fixed Asset" as an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business".²
- (b) The Order does not define as to what constitutes 'proper records'. In general, however, the records relating to fixed assets should contain, *inter alia*, the following details:
- (i) sufficient description of the asset to make identification possible;
 - (ii) classification, that is, the head under which it is shown in the accounts, e.g., plant and machinery, office equipment, etc;
 - (iii) situation;
 - (iv) quantity, i.e., number of units;
 - (v) original cost;
 - (vi) year of purchase;
 - (vii) useful life;
 - (viii) residual Value;
 - (ix) component-wise breakup; (Wherever applicable)
 - (x) adjustment for revaluation or for any increase or decrease in cost;

¹ Here it may be noted that the revised Accounting Standard (AS) 10, *Property Plant and Equipment* (issued as per MCA's Notification No. 364(E) dated 30th March 2016 and effective for the accounting periods commencing on or after the date of the said Notification *vide* circular no. 04/2016 dated 27th April, 2016[#]) that replaces the Accounting Standard (AS) 10, *Fixed Assets*, (issued under the Companies (Accounting Standards) Rules, 2006) defines the term "*Property, plant and equipment*" as "*tangible items that:*

(a) *are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and*

(b) *are expected to be used during more than a period of twelve months."*

[#] Inserted at the time of printing.

² As per AS 26, Intangible Assets, an Intangible Asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

III.750 Auditing Pronouncements

- (xi) date of revaluation, if any;
 - (xii) rate(s)/basis of depreciation or amortisation, as the case may be;
 - (xiii) depreciation/amortisation for the current year;
 - (xiv) accumulated depreciation/amortisation;
 - (xv) particulars regarding impairment;
 - (xvi) particulars regarding sale, discarding, demolition, destruction, etc.
- (c) The records should contain the above-mentioned particulars in respect of all items of fixed assets, whether tangible or intangible, self-financed or acquired through finance lease. These records should also contain particulars in respect of those items of fixed assets that have been fully depreciated or amortised or have been retired from active use and held for disposal. The records should also contain necessary particulars in respect of items of fixed assets that have been fully impaired during the period covered by the audit report.

Thus, what constitutes proper records is a matter of professional judgment made by the auditor after considering the facts and circumstances of each case.

- (d) It is necessary that the aggregate original cost, depreciation or amortisation to date, and impairment loss, if any, as per these records under individual heads should reconcile with the figures shown in the books of account.
- (e) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account keeping (manual or computerized), the number of operating locations, the systems of control, etc. It may be noted that with the widespread use of the information technology, many companies maintain electronic records. In fact, section 2(12) of the Act, defines the terms “book and paper” and “book or paper” as including books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form”. Rule 3 of the Companies (Accounts) Rules, 2014 dealing with the “manner of books of account to be kept in electronic mode” states as under:
- “(1) The books of account and other relevant books and papers maintained in electronic mode shall remain accessible in India so as to be usable for subsequent reference.
 - (2) The books of account and other relevant books and papers referred to in sub-rule (1) shall be retained completely in the format in which they were originally generated, sent or received, or in a format which shall present accurately the information generated, sent or received and the information contained in the electronic records shall remain complete and unaltered.
 - (3) The information received from branch offices shall not be altered and shall be

kept in a manner where it shall depict what was originally received from the branches.

- (4) The information in the electronic record of the document shall be capable of being displayed in a legible form.
- (5) There shall be a proper system for storage, retrieval, display or printout of the electronic records as the Audit Committee, if any, or the Board may deem appropriate and such records shall not be disposed of or rendered unusable, unless permitted by law.”

The Rule further explains that the term “electronic mode” includes “electronic form” as defined in section 2(1)(r) of the Information Technology Act, 2000 and also includes an electronic record as defined in section 2(1)(t) of the Information Technology Act, 2000 (as amended by the Amendment Act of 2008)³. Accordingly, where any law requires that any information or matter should be in the typewritten or printed form, then such requirement shall be deemed to be satisfied if it is in an electronic form. However, it will have to be ensured that the information contained in the electronic records remains accessible and unaltered and its origin, destination, date, etc., can be identified.

Audit Procedures and Reporting

- (f) The auditor may, therefore, accept fixed assets register in electronic form if the following two conditions are satisfied:
 - (i) The controls and security measures in the company are such that once finalised, the fixed assets register cannot be altered without proper authorization and audit trail.⁴
 - (ii) The fixed assets register is in such a form that it can be retrieved in a legible form. In other words, the emphasis is on whether it can be read on the screen or a hard copy can be taken. If this is so, one can contend that it is capable of being retrieved in a legible form.

³ Section 2(1)(r) of the Information Technology Act, 2000 defines “electronic form” as follows: “electronic form” with reference to information means any information generated, sent, received or stored in media, magnetic, optical, computer memory, micro film, computer generated micro fiche or similar device”

Section 2(1)(t) of the information Technology Act, 2000 defines “electronic records” as follows: “electronic record” means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche.”

⁴ In this context, attention of the members is also drawn to Standard on Auditing (SA) 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” as also the “Guidance Note on Audit of Internal Financial Controls Over Financial Reporting”, issued by ICAI.

III.752 Auditing Pronouncements

In case the above two conditions or either of the two conditions are not satisfied, the auditor should obtain a duly authenticated print-out of the fixed assets register. In case the auditor decides to rely on electronically maintained fixed assets register, he should maintain adequate documentation evidencing the evaluation of controls that seek to ensure the completeness, accuracy and security of the register.

- (g) The purpose of showing the situation of the assets is to make verification possible. There may, however, be certain classes of fixed assets whose situation keeps changing, for example, construction equipment which has to be moved to sites. In such circumstances, it should be sufficient if record of movement/custody of the equipment is maintained.
- (h) Where assets like furniture, etc., are located in the residential premises of members of the staff, the fixed assets register should indicate the name & designation of the person who has custody of the asset for the time being.
- (i) While, generally, the quantity, value and situation have to be recorded item-wise, assets of small individual value, e.g., chairs, tables, etc., may be conveniently grouped for purposes of entry in the register. Similarly, for assets having same useful life, it may not be necessary to indicate the accumulated depreciation for each item; instead, depreciation for the group as a whole may be shown.
- (j) Quantitative details in respect of fixed assets may be maintained on the following lines:
 - (i) Land may be identified by survey numbers and by deeds of conveyance.
 - (ii) Leaseholds can be identified by individual leases.
 - (iii) Buildings may, initially, be classified into factory buildings, office buildings, township buildings, service buildings (like water works), etc. These may then be further sub-divided. Factory buildings may be further classified into individual buildings which house a manufacturing unit or a plant or sub-plant. Service buildings may be similarly classified according to nature of service and location. Township buildings can be further classified into individual units or into groups of units taking into consideration the type of construction, the location and the year of construction. For example, if a company's township has four categories of quarters, e.g., A, B, C and D, the fixed assets register may not record each individual quarter but may have a single entry for all 'A' type quarters constructed in a particular year and located in a particular area and show only the number of quarters covered by the entry.
 - (iv) Railway sidings can be identified by length and location.
 - (v) Plant and Machinery may be sub-divided into fixed and movable. For

movable machinery, a separate record may be kept for each individual item. Movable machinery would include, for this purpose, items of plant which are for the moment fixed to the shop-floor but which can be moved, e.g., machine tools. In respect of fixed plant and machinery, a sub-division can be made according to the process, a plant for each separate process being considered as a separate identifiable unit. A further sub-division may be useful when within a process, there are plants which are capable of working independently of each other. The degree to which a sub-division of fixed plant and machinery should be made depends upon the circumstances of each case bearing in mind the objectives of sub-division, namely, the determination of individual cost and the facility for physical verification and componentisation⁵.

- (vi) Furniture and fittings and assets like office appliances, air-conditioners, water coolers, etc., consist of individual items which can be easily identified. Some difficulty may, however, be faced with regard to the large number of items and their relative mobility. In such cases, a distinction by value may be necessary, individual identification being made for high-value items and by groups for other items.
- (vii) Development of property is an asset head which can be easily sub-divided according to the buildings or plant for which the development work is undertaken.
- (viii) Patents, trademarks and designs are normally identifiable by the purchase agreements or the letters granting patent and by registration references in case of trademarks and designs. Intangible assets can be identified by reference to the purchase agreements (in case an intangible asset has been purchased) and by reference to the records and documents that substantiate the costs incurred by the company in the generation and development of an intangible asset.
- (ix) Vehicles can be identified by reference to the registration books.
- (k) In cases where the details regarding allocation of cost over identified units of assets are not available, it would have to be made by an analysis of the purchases and the disposals of the preceding years. Among the difficulties which may be faced could be: (i) records for some of the years may not be available; (ii) the description in the records may not be complete; (iii) details of disposals may not have been properly recorded; (iv) subsequent additions to an existing asset may have been shown as a separate asset; (v) a single figure of cost may be assigned to a number of assets

⁵ Attention of the readers is invited to the requirements of Schedule II to the Companies Act 2013 in respect of componentisation.

III.754 Auditing Pronouncements

which have to be separately identified; (vi) assets purchased for one department may have been moved to other departments, and so on. The management, in consultation with the auditor, should make the best effort possible under the circumstances to identify the cost of each asset. In doing so, reasonable assumptions or approximations may be made, where necessary. For example, when details of disposals are not available, it may be assumed that the asset sold is the asset which was acquired earliest in point of time. Similarly, when the individual cost of a large number of small items is not available, one can estimate the cost of each item and pro-rate the total cost in the proportion of the estimated cost of the item to the aggregate estimated cost.

- (l) It may be useful if initial identification of assets is done by persons who are familiar with them, e.g., the maintenance staff. At the point of identification, a code number may be affixed on the asset which would give sufficient details for future identification.
- (m) The initial identification of assets will often reveal a number of discrepancies between the assets as verified and the details compiled from the records. This may be on account of the features already considered in (k) above. This may also be due to the fact that assets might have been scrapped in earlier years but proper documentation may not have been made or that assets may have been broken up into smaller units or amalgamated into larger units or otherwise modified without changing the asset records. The degree of further inquiry necessary to reconcile these discrepancies would depend upon the nature of the asset, its cost, the age of the asset, the extent of accounting or other records available and other relevant factors. However, the concept of materiality should be borne in mind in making these further inquiries, greater attention being devoted to assets which are of large value or of relatively recent purchase. Any adjustments that finally have to be made should be properly documented. The auditor should request the appropriate level of management to carry out necessary adjustments.

35. *Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account; [Paragraph 3(i)(b)]*

Relevant Provisions

- (a) The clause requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable intervals. The clause further requires the auditor to comment whether any material discrepancies were noticed on such verification and if so, whether those discrepancies have been properly dealt with in the books of account.

- (b) Physical verification of the assets is the responsibility of the management and, therefore, has to be carried out by the management itself and not by the auditor. It is, however, necessary that the auditor satisfies himself that such verification was done and that there is adequate evidence on the basis of which he can arrive at such a conclusion. The auditor may prefer to observe the verification, particularly when verification of all assets can be made by the management on a single day or within a relatively short period of time. If, however, verification is a continuous process or if the auditor is not present when verification is made, then he should examine the instructions issued to the staff (which should, therefore, be in writing) by the management and should examine the working papers of the staff to substantiate the fact that verification was done and to determine the name and competence of the person who did the verification. In making this examination, it is necessary to ensure that the person making the verification had the necessary technical knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible for verification to be made by outside expert agencies engaged by the management for the purpose.

Audit Procedures and Reporting

- (c) The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land.
- (d) It is advisable that the assets are marked with "distinctive numbers" especially where assets are movable in nature and where verification of all assets is not being conducted at the same time.
- (e) The Order requires the auditor to report whether the management has verified the fixed assets at reasonable intervals. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of

III.756 Auditing Pronouncements

assets, difficulty in verification, situation and geographical spread of the location of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

- (f) The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material. The auditor has, therefore, to use his judgement to determine whether a discrepancy is material or not. In making this judgement, the auditor should consider not merely the cost of the asset and its relationship to the total cost of all assets but also the nature of the asset, its situation and other relevant factors. If a material discrepancy has been properly dealt with in the books of account (which may or may not imply a separate disclosure in the accounts depending on the circumstances of the case), it is not necessary for the auditor to give details of the discrepancy or of its treatment in the accounts but he is required to make a statement that a material discrepancy was noticed on the verification of fixed assets and that the same has been properly dealt with in the books of account.

36. *Whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof; [Paragraph 3(i)(c)]*

Relevant Provision

- (a) The clause requires the auditor to comment whether the title deeds of immovable properties are held in the name of the company, if not, to provide the details thereof. This clause shall cover the immovable properties which are included under the head Fixed Assets, as the reporting under Clause 3(i)(a) & 3(i)(b) pertains to Fixed Assets only.
- (b) The Act does not define the term "Immovable Property". However, as per General Clauses Act, 1897, "Immovable Property" shall include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth.

Audit Procedures and Reporting

- (c) Based on review of the Fixed Assets Register, the auditor is required to identify immovable properties and verify the title deeds of such immovable properties. TDRs

(Transfer Development Rights), Plant and Machinery embedded in land etc., are not considered as an immovable property.

- (d) The Order is silent as to what constitutes 'title deeds'. In general, title deeds means a legal deed or document constituting evidence of a right, especially to the legal ownership of the immovable property.
- (e) Following documents mainly constitute title deeds of the immovable property:-
 - (i) Registered sale deed / transfer deed / conveyance deed, etc. of land, land & building together, etc. purchased, allotted, transferred by any person including any government, government authority / body/ agency / corporation, etc. to the company.
 - (ii) In case of leasehold land and land & buildings together, covered under the head fixed assets, the lease agreement duly registered with the appropriate authority.
- (f) The auditor should carry out detailed examination in the cases where immovable property is transferred as a result of conversion of partnership firm or LLP into company or amalgamation of companies, as in such cases title deeds may be in the name of the erstwhile entity.
- (g) Where the title deeds of the immovable property have been mortgaged with the Banks/ Financial Institutions, etc., for securing the borrowings and loan raised by the company, a confirmation about the same should be sought from the respective institution to this effect. The auditor may also consider verifying this information from the online records, if available, of the relevant State.
- (h) There may be instances where the title deeds were lost accidentally or otherwise. In such cases, the certified copies of the documents, as available with the company, and details about the FIR filed, about loss of such documents needs to be obtained and documented. The auditor should also seek written representation from the management in this regard.
- (i) The management is responsible for legal determination of the validity of title deeds, the auditor may refer SA 250 "Consideration of Laws and Regulations in an audit of Financial Statements" to the extent considered relevant and obtain sufficient and appropriate audit evidence. Further any discrepancy, including any pending/disputed court cases relating to ownership, needs detailed discussion with the management and should be properly documented. In this context, the auditor may also consider communicating with the legal counsel, whether in-house or external, in accordance with the principles enunciated in SA 501, *Audit Evidence* –

III.758 Auditing Pronouncements

Specific Considerations for Selected Items. The auditor may also consider disclosing the dispute while reporting under this clause.

- (j) The auditor should verify the title deeds available and reconcile the same with the fixed assets register. The scrutiny of the title deeds of the immovable property may reveal a number of discrepancies between the details in the fixed assets register and the details available in the title deeds. This may be due to various reasons which needs to be examined.
- (k) The reporting under this clause, where the title deeds of the immovable property are not held in the name of the Company, may be made incorporating following details, in the form of a table or otherwise:
 - a. **In case of land:-**
 - total number of cases,
 - whether leasehold / freehold,
 - gross block and net block, (as at Balance Sheet date), and
 - remarks, if any.
 - b. **In case of Buildings:-**
 - total number of cases,
 - gross block & net block, (as at Balance Sheet date) and
 - remarks, if any.

37. *Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account; [Paragraph 3(ii)]*

Relevant Provisions

- (a) The clause requires the auditor to comment whether the management has conducted physical verification of inventory at reasonable intervals. The clause also requires the auditor to comment whether any material discrepancies were noticed on physical verification of inventory and if so, whether those material discrepancies have been properly dealt with in the books of account.
- (b) According to Accounting Standard (AS) 2, "Valuation of Inventories":

"Inventories are assets:

 - (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process

or in the rendering of services.”

- (c) Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, stores and spares, consumables and loose tools awaiting use in the production process. It may be noted that packing materials are also included in inventories. Inventories do not include machinery spares covered by Accounting Standard (AS) 10, “Accounting for Fixed Assets”, which can be used only in connection with an item of fixed asset and the use of which is expected to be irregular⁶.

Audit Procedures and Reporting

- (d) Physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases. It is, however, necessary that the auditor satisfies himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can arrive at such a conclusion. For example, the auditor may examine the documents relating to physical verification conducted by the management during the year as also at the end of the financial year covered by the auditor’s report.
- (e) What constitutes “reasonable intervals” depends on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. The management of a company normally determines the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all the items of inventories should be verified by the management of the company at least once in a year. It may be useful for the company to determine the frequency of verification by ‘A-B-C’ classification of inventories, ‘A’ category items being verified more frequently than ‘B’ category and the latter more frequently than ‘C’ category

⁶ Here it may be noted that paragraph 4 of the revised Accounting Standard (AS) 2, *Valuation of Inventories*, (issued as per MCA’s Notification No. 364(E) dated 30th March 2016 and effective for the accounting periods commencing on or after the date of the said Notification vide circular no. 04/2016 dated 27th April, 2016[#]) states that:

“Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10, *Property, Plant and Equipment*. Such items are accounted for in accordance with Accounting Standard (AS) 10, *Property, Plant and Equipment*.”

[#] Inserted at the time of printing.

III.760 Auditing Pronouncements

items.

- (f) The Order further requires the auditor to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. If the item for which the discrepancy cannot be established is not material, the discrepancy, if any, will also not be material. For example, an item categorised as 'C' in ABC analysis might not be material and therefore, the discrepancy, if any, in regard to such an item would not be material. In other cases, however, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items to be specified.

38. *Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,*

- a) **whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;**
- b) **whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;**
- c) **if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest; [Paragraph 3(iii)]**

Relevant Provisions

- (a) There are three clauses under paragraph 3(iii) of the Order. It is clarified that the auditor's comments on all the three clauses are to be made with reference to the loans granted to companies, firms, limited liability partnerships or other parties covered in the register maintained under section 189 of the Act.
- (b) Clause 3(iii)(a) covers determination of terms and conditions at the time of the grant of the loan. In this regard it may be noted that though the clause uses the term "grant" which would ordinarily be understood to mean loans granted/given during the year, however, it may be appropriate to include such loans also that were renewed

during the year. Clauses 3(iii)(b) and 3(iii)(c) cover the loans granted during the year and also all loans having opening balances.

Audit Procedures and Reporting

- (c) The duty of the auditor, under this clause, is to determine whether the company has granted any loans, secured or unsecured to companies, firms, limited liability partnerships or other parties covered in the register maintained under section 189 of the Act. If the company has done so, the auditor should report on the matters specified in sub-clauses (a), (b) and (c) of the clause 3(iii). The auditor is required to disclose the requisite information in his report in respect of all parties covered in the register maintained under section 189 of the Act irrespective of the period to which such loan relates. Further, there is no stipulation regarding the loan being given in cash or in kind. In the absence of such stipulation, the auditor is required to disclose the requisite information as specified in sub-clauses (a), (b) and (c) of the clause 3(iii), in his report in respect of all kind of loans whether long term or short term, whether given in cash or in kind to the parties covered in the register maintained under section 189 of the Act.
- (d) Under section 189 of the Act, every company is required to maintain one or more registers which contain the particulars of all contracts or arrangements to which sub-section (2) of section 184 or section 188 of the Act applies. The particulars of all contracts or arrangements in which directors are interested is required to be maintained by every company in Form MBP-4 as specified in Rule 16(1) of the Companies (Meetings of Board and its Powers) Rules, 2014. It is, however, suggested that the auditor should acquaint himself with all the requirements of sections 184, 188 and 189 of the Act and rules there under.
- (e) The auditor should obtain a list of companies, firms, limited liability partnerships or other parties covered in the register maintained under section 189 of the Act from the management. The auditor may also consider verifying returns filed or certificates obtained by the management in this regard. The auditor should examine all loans (secured or unsecured) granted by the company to identify those loans granted to companies, firms, limited liability partnerships or other parties covered in the register maintained under section 189 of the Act.
- (f) It may so happen that a party listed in the register maintained under section 189 of the Act might have taken a loan from a company and repaid it during the same financial year. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared-up during the year and report such transactions under this clause. For example, the company has, during the financial year, granted a loan of Rs. 1,00,000/- to a firm in which one of the directors of the company is interested and the firm repays the loan during the

III.762 Auditing Pronouncements

financial year concerned. The auditor is also required to consider such transaction while commenting upon this clause of the Order.

A. Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest; [Paragraph 3(iii)(a)]

Relevant Provision

- (a) This clause, read with Paragraph 3(iii) of the Order, requires the auditor to examine and comment whether the terms and conditions of loans granted by the company (whether secured or unsecured) to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Act are prejudicial to the interest of the company.

Audit Procedures and Reporting

- (b) The auditor should examine agreements entered into by the company with the parties covered in the register maintained under section 189 of the Act or any other supporting documents available for ascertaining the terms and conditions of all loans granted by the company to such companies, firms, Limited Liability Partnerships or other parties.
- (c) The auditor's duty is to determine whether, in his opinion, the terms and conditions of the loans given are prejudicial to the interest of the company. The "terms and conditions" would primarily include rate of interest, security, terms and period of repayment and restrictive covenants, if any. In determining whether the terms of the loans are prejudicial, the auditor would have to give due consideration to the other factors connected with the loan, including its ability to lend, terms of its borrowings, borrower's financial standing, credit rating, if available, the nature of the security, rate of interest and so on.

For the purpose of reporting under this clause the auditor may consider clause (7) of Section 186 of the Act wherein it is specified that no loan, covered under this section, shall be given at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year government security closest to the tenor of the loan, to the extent applicable.

- (d) It may be mentioned that clause (a) of sub-section (1) of section 143 of the Act also requires the auditor to inquire whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members. The auditor's inquiry under the aforesaid clause may also be useful for the purposes of reporting under this clause.
- (e) Further, the auditor may also come across a situation where the company has a policy of providing loans at concessional rates of interest to its employees and such

a loan has been given to a relative of the director who is also an employee of the company. In such a case also, the auditor would be required to examine and comment whether loan is prejudicial to the interests of the company. It may, however, be noted that normally such terms as per the policy followed by the company cannot be said to be prejudicial to the interest of the company if other employees of the company also receive the loan on the same terms.

- (f) The following is an example of an unfavourable comment by the auditor under this clause:

“According to the information and explanations given to us and based on the audit procedures conducted by us, we are of the opinion that the terms and conditions of loans granted by the company to two parties covered in the register maintained under section 189 of the Companies Act, 2013, (total loan amount granted Rs ---- and balance outstanding as at balance sheet date Rs -----) are prejudicial to the company’s interest on account of the fact that the loans have been granted at an interest rate of X% per annum which is significantly lower than the cost of funds to the company and also lower than the prevailing yield of government security close to the tenor of the loan”

B. Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular; [Paragraph 3(iii)(b)]

Relevant Provision

- (a) This part of the clause requires the auditor to report upon the stipulation of schedule of repayment of principal and payment of interest and on regularity of repayments of principal amount of loans and receipts of interest thereon. The scope of auditor’s inquiry under this clause is restricted in respect of companies, firms, Limited Liability partnerships or other parties covered in the register maintained under section 189 of the Act.

Audit Procedures and Reporting

- (b) The auditor has to examine from the loan agreements / mutually agreed letter of arrangement, as the case may be, whether the schedule of repayment of principal and payment of interest has been stipulated at the time of sanction. If there is no such agreement / arrangement or the agreement / arrangement does not contain the schedule of repayment of principal and payment of interest, the auditor shall report that there is no stipulation of schedule of repayment of principal and payment of interest.
- (c) The auditor has to examine whether the repayment of principal and receipt of interest are regular. The word ‘regular’ should be taken to mean that the principal and interest should normally be received whenever they fall due, respectively.

III.764 Auditing Pronouncements

- (d) In case where the auditee company is a non-banking financial company, the auditor, for reporting under this clause, would also need to refer various directions for non-banking financial companies issued by Reserve Bank of India.
- (e) In case of non-stipulation of schedule of repayment of principal & payment of Interest, the auditor should state the fact and may report that he is unable to make specific comment on the regularity of repayment of principal & payment of interest, in such cases.
- (f) In case where the schedule of repayment of principal & payment of interest is stipulated but repayment of principal or payment of interest is not regular then the auditor may report the fact and may give no. of cases and remarks, if any.

C. If the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest; [Paragraph 3(iii)(c)]

Relevant Provision

- (a) This clause requires the auditor to state the total amount overdue for more than 90 days and whether reasonable steps have been taken by the company for recovery of the principal and interest. An amount is considered to be overdue when the payment has not been received on the due date as per the lending arrangement. In such cases, the auditor has to examine the steps, if any, taken for recovery of this amount. It may, however, be noted that the scope of the auditor's inquiry under this clause is restricted to loans given by the company to parties covered in the register maintained under section 189 of the Act.

Audit Procedures and Reporting

- (b) Under this clause, the auditor is required to disclose total amount overdue for more than 90 days. The auditor should examine the agreement or other documents containing the schedule of repayment of the loans granted to parties covered in the register maintained under section 189 of the Act. The auditor should then verify whether the repayments as per the books of account are in accordance with the schedule of repayment of the loans as per agreement or arrangement. This examination would enable the auditor to determine the total amount overdue (principal and interest) for more than 90 days from such parties as at balance sheet date. The auditor should disclose the aggregate of the total amount of overdue for more than 90 days in respect of loans granted to such parties.
- (c) While examining whether reasonable steps have been taken by the company for recovery of principal and interest, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the

circumstances, the degree of delay in recovery and other similar factors, issue of reminders or the sending of an advocate's or solicitor's notice, may amount to "reasonable steps" even though no legal action is taken. The auditor is not, therefore, required to comment on the mere absence of legal steps if he is otherwise satisfied that reasonable steps have been taken by the company. The auditor should obtain sufficient appropriate audit evidence to support the fact that reasonable steps have been taken for recovery of the principal and interest of loans granted by the company. The auditor should ask the management to give in writing, the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations and other relevant evidence.

- (d) Reporting of such cases may be made incorporating following details:

No. of Cases

Principal Amount Overdue

Interest Overdue

Total Amount Overdue

Remarks, if any (specify whether reasonable steps have been taken by the Company for recovery of principal amount and interest)

39. In respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof. [Paragraph 3(iv)]

A. Compliance of Section 185 of the Companies Act 2013: Loan to directors, etc.

Relevant Provisions

- (a) Under this clause the auditor is required to report on the compliance of Section 185 of the Act. The text of section 185 is reproduced in **Appendix V** to this Guidance Note.

Audit Procedures and Reporting

- (b) For this purpose, the auditor should carry out the following procedures:
- (i) Obtain from the management the details of the directors or any other person in whom the director is interested. He may also check the details of the persons covered under this clause from Form MBP-1 and from the Register maintained u/s 189 of the Act.

III.766 Auditing Pronouncements

- (ii) Obtain and check the details of the transactions carried out with such persons, including of any guarantee given and security provided.
 - (iii) Further examine the details to find out whether any of the transaction is attracting the provisions of section 185 of the Act.
 - (iv) In case of transactions that are covered under the exceptions as provided under section 185, the auditor should obtain the necessary evidence in support of such exception.
- (c) Section 185 prohibits advance of any loan to directors, etc., directly or indirectly. What is an indirect loan is not defined in section 185 or elsewhere in the Act. Indirect is interpreted in case of *Dr. Freddie Ardeshir Mehta v. Union of India* [1991] 70 Comp. Cas. 210 (Bom.) to mean a loan to a director through the agency of one or more intermediaries. For example, if company A borrows from company B and lends the same to company C and loan from B to C is covered by section 185. In this case section 185 shall also be applicable in case of lending from company A to C because it would be construed as an indirect loan from B to C.
- (d) The auditor should report the nature of non-compliance, the maximum amount outstanding during the year and the amount outstanding as at the balance sheet date in respect of
- (i) the Directors; and
 - (ii) persons in whom directors are interested (specify the relationship with the Director concerned).

B. Compliance of Section 186 of the Companies Act 2013: Loan and investment by company

Relevant Provisions

- (a) Under this clause the auditor is also required to report on the compliance of Section 186 of the Act, which governs giving of loans, and guarantee or providing and security in connection with a loan, by a company to any person or other body corporate and acquiring securities of any other body corporate by a company. The section also prohibits a company from making investments through more than two layers of investment companies. The text of Section 186 and relevant extract of Rules 11, 12 & 13 of Companies (Meeting of Board and its Powers) Rules, 2014 is reproduced in **Appendix V** to this Guidance Note.

Audit Procedures and Reporting

- (b) The duty of the auditor under this clause is to determine whether the loans and investments made by the company comply with the requirements of the provisions of Section 186 of the Act.

For this purpose, the auditor should:

- (i) Obtain the details of, loans given to any person or other body corporate, guarantee given or security provided in connection with a loan to any other body corporate or person and securities acquired of any other body corporate by way of subscription, purchase or otherwise, made during the year as well as the outstanding balances as at the beginning of the year.
- (ii) Check whether, at any point of time during the year in case of aforesaid transactions, the company has exceeded the limit of sixty per cent of its paid-up share capital, free reserves and securities premium account or one hundred per cent of its free reserves (as defined in section 2(43) of the Act and securities premium account, whichever is more.

If it exceeds the limits specified above, whether prior approval by means of a special resolution passed at a general meeting has been obtained.

- (iii) Check whether the company has made investments through more than two layers of investment companies.⁷
- (iv) Check whether the company has disclosed the full particulars of the loan given, investment made or guarantee given or security provided in the financial statement including the purpose for which the same is proposed to be utilized by the recipient.
- (v) Check whether the company has passed the board resolution as prescribed and obtained the prior approval, wherever required, from the public financial institution concerned where any term loan is subsisting.
- (vi) Check whether the loan has been given to company registered under section 12 of the Securities and Exchange Board of India Act, 1992, if so, whether the inter-corporate loan or deposits taken by such company are within the limits prescribed, if so, obtain the certificate of statutory auditors of that company from the management to ensure the compliance.

⁷ The Sub section 1 of Section 186 which restricts investment through more than two layers of investment companies is proposed to be deleted by Companies (Amendment) Bill, 2016 pending at appropriate level for approval.

III.768 Auditing Pronouncements

- (vii) Check whether rate of interest is not lower than the prevailing yield of one year, three year, five year or ten year government security closest to the tenor of the loan granted.
 - (viii) Check if the company is in default in the repayment of any deposits accepted or in payment of interest thereon, then the company is not allowed to give any loan or guarantee or any security or an acquisition till such default is subsisting.
 - (ix) Check whether the company has maintained a register (as per Form MBP-2) in the manner as prescribed and also check the compliances of other provisions and relevant rules.
 - (x) It may be noted that the aforesaid section is not applicable in respect of loan made, guarantee given or security provided by banking company or an insurance company or a housing finance company in the ordinary course of its business or a company engaged in the business of financing of companies or of providing infrastructural facilities. However the restriction with regard to the investment through more than two layers of investment companies would be applicable for such companies also. The auditor may ensure compliance accordingly.
- (c) It may also be noted that the provisions of section 186 of the Act shall not apply to a government company engaged in defence production and a government company, other than a listed company, in case such company obtains approval of the ministry or department of the central government which is administratively in charge of the company, or, as the case may be, the State Government before making any loan or giving any guarantee or providing any security or making any investment under the section. [vide Notification F. No. 1/2/2014-CL.V dated 5th June 2015]

Non-compliance may be reported incorporating following details:-

S. No.	Non-compliance of Section 186			Remarks, if any
	Name of Company/ Party	Amount Involved	Balance as Balance at Balance Sheet Date	
1.	Investment through more than two layers of investment companies			
2.	Loan given or guarantee given			

	or security provided or acquisition of securities exceeding the limits without prior approval by means of a special resolution				
3.	Loan given at rate of interest lower than prescribed				
4.	Any other default				

40. In case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed thereunder, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not? [Paragraph 3(v)]⁸

Relevant Provisions

- (a) The clause, in addition to requiring the auditors to report on compliance with the requirements of sections 73 to 76 of the Act, and the directives of the Reserve Bank of India for acceptance of public deposits, also requires the auditor to report on compliance with the order, if any, passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal.
- (b) Section 2(31) has defined 'deposit' to include any receipt of money by way of deposit or loan or in any other form by a company, but does not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India.
- (c) Section 73 of the Act, prohibits a company (other than a banking company, non-banking financial company (NBFC) and such other company as may be specified by the central government in consultation with the Reserve Bank of India), to invite,

⁸ The text of sections 73 to 76 of the Act is reproduced in **Appendix XII** to this Guidance Note. The text of the Companies (Acceptance of Deposits) Rules, 2014 is given in **Appendix XIII** to this Guidance Note.

III.770 Auditing Pronouncements

accept or renew deposits from the public except in the manner provided in this section and the Companies (Acceptance of Deposits) Rules, 2014.

- (d) Section 76 of the Act, permits the public companies having specified net worth or turnover, to accept deposits from persons other than its members subject to compliance with section 73 and the Companies (Acceptance of Deposits) Rules, 2014.
- (e) The central government in consultation with the Reserve Bank of India has notified the Companies (Acceptance of Deposits) Rules, 2014. These Rules are not applicable to a banking company, a NBFC, a housing finance company and a company specified by the central government under the proviso to sub-section (1) of section 73 of the Act.
- (f) The Companies (Acceptance of Deposits) Rules, 2014 cover the following main items:
 - (i) the nature of deposits which may be accepted;
 - (ii) the terms and conditions of acceptance of deposits by companies from its members and persons other than its members;
 - (iii) the limits up to which the deposits can be accepted;
 - (iv) the form and particulars of advertisement for deposits;
 - (v) the form of application for deposits;
 - (vi) furnishing of deposit receipts to depositors;
 - (vii) Maintenance of liquid assets, creation of security and appointment of trustee for depositors;
 - (viii) maintenance of register(s) of depositors;
 - (ix) Manner and extent of deposit insurance;
 - (x) general provisions regarding the repayment of deposits and payment of interest;
 - (xi) the returns to be filed with the Registrar of Companies.

Audit Procedures and Reporting

- (g) The auditor should plan to test for compliance with the provisions of sections 73 to 76 of the Act and the Rules made thereunder i.e. the Companies (Acceptance of Deposits) Rules, 2014. For such purpose, the auditor should also obtain an understanding of the requirements of sections 73 to 76 and rules thereunder.
- (h) The auditor should examine compliance by the company with regard to all the matters specified in the sections and the Rules and not merely to the limits of the deposits. Where the number of deposits is very large, it is obviously not feasible for the auditor to satisfy himself that every single deposit complies with the rules. He should, therefore, examine the system by which deposits are accepted and records

are maintained and make a reasonable test check to ensure the correctness of the system. The auditor may also make a “check list” to ensure that all the requirements of the Rules regarding the records to be maintained, returns to be filed, etc., are complied with.

- (i) The auditor should examine the efficacy of the internal controls instituted by the company so that the deposits accepted by the company remain within the limits. It may be difficult for the auditor to ascertain that deposits accepted by the company are within the limits on each day of the accounting year. He would, therefore, be justified in making a reasonable test check to ensure that the company has not accepted deposits during the year in excess of the limits. For financing companies, the auditor should make a similar examination having regard to the Reserve Bank directives in force from time to time.
- (j) Apart from the audit procedures mentioned above, the auditor should also enquire from the management about the possible instances of non-compliance with sections 73 to 76 or any other relevant provisions of the Act and the relevant rules. The auditor should also enquire from the management about any order passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal for contravention of these sections or any other relevant provision(s) of the Act and the relevant rules. The auditor should obtain a management representation to the effect whether:
 - (i) the company has complied with the directives issued by the Reserve Bank of India and the provision of section 73 to 76 (as the case may be) of the Act and the relevant rules; and
 - (ii) where an order has been passed by any of the relevant authorities mentioned in the clause, and if so, the company has complied with the requirements of the Order.
- (k) In case where the auditor is of the view that any kind of contravention of sections 73 to 76 or any other relevant provisions of the Act or relevant rules or directives from Reserve Bank of India, if any, has taken place, the auditor should state in his report that the provisions of that section(s) and/or relevant rules, as the case may be, have not been complied with. The auditor should also report the nature of contraventions.
- (l) The auditor, under this clause, is required to verify whether the company has complied with the order passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal. Where any of such authorities has passed an order, the auditor should examine the steps taken by the company to comply with the said order. If the company has not complied with the order, the same is to be reported stating therein the nature of contravention and the fact that the company has not complied with the order issued by the Company

III.772 Auditing Pronouncements

Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal.

41. *Whether maintenance of cost records has been specified by the Central Government under sub-section (1) of Section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained. [Paragraph 3(vi)]*

Relevant Provisions

(a) Section 148(1) of the Act, specifies that the Central Government may, by order, in respect of such class of companies engaged in production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilization of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies. Pursuant to this requirement and in exercise of the powers conferred by sub-section (1) of section 469 of the Act, the Central Government has made rules in respect of a number of classes of companies. These books of account and records form part of the books of account of the company within the meaning of Section 2(13) of the Act.

In exercise of the power conferred by sub-section (1) and (2) of section 469 and section 148 of the Act, the Central Government has issued the Companies (Cost Records and Audit) Rules, 2014 which has specified the list of class of companies in which maintenance of cost record is prescribed under section 148 of the Act. The Companies (Cost Records and Audit) Rules, 2014 are reproduced in **Appendix VI** to this Guidance Note.

(b) The Companies (Cost Records and Audit) Rules, 2014 has defined “cost records” as books of account relating to utilization of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in section 148 of the Act, and these rules. These rules also prescribed the items of cost to be included in the Books of Account.

(c) Sub-section (2) of Section 148 of the Act, also provides that where, in the opinion of the Central Government, it is necessary to do so it may by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

(d) Rule 4 of the aforesaid Rules lays down the conditions subject to which the companies covered by these Rules need to get their cost records audited.

Audit Procedures and Reporting

(e) The Order requires the auditor to report whether cost accounts and records have

been made and maintained. The word “made” applies in respect of cost accounts (or cost statements) and the word “maintained” applies in respect of cost records relating to materials, labour, overheads, etc. The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the central government. The auditor should obtain a written representation from the management stating (a) whether cost records are required to be maintained for any product(s) or services of the company under section 148 of the Act, and the Companies (Cost Records and Audit) Rules, 2014; and (b) whether cost accounts and records are being made and maintained regularly. The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore, conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.

- (f) It is necessary that the extent of the examination made by the auditor is clearly brought out in his report. The following wording is, therefore, suggested:

“We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 148 of the Act, and are of the opinion that *prima facie*, the prescribed accounts and records have been made and maintained.”

- (g) Where the auditor finds that the records have not been written or are not *prima facie* complete, it will be necessary for the auditor to make a suitable comment in his report.

42. *Whether the company is regular in depositing undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated; [Paragraph 3(vii)(a)]*

Relevant Provisions

- (a) This clause requires the auditor to report upon the regularity of the company in depositing undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess and any other statutory dues to appropriate authorities. If the company is not regular in depositing the above mentioned undisputed statutory dues, the auditor is required to state the extent of arrears of statutory dues which

III.774 Auditing Pronouncements

have remained outstanding as at the last day of the financial year concerned for a period of more than six months from the date they became payable.

- (b) It may be noted that the use of the words “any other statutory dues” indicates that the clause covers all type of dues under various statues which may be applicable to a company having regard to its nature of business. Apart from the statutory dues listed, the auditor is required to report on the regularity of the company in depositing “any other statutory dues” payable by the company to appropriate authorities under the statutes applicable to the company.
- (c) The intention of the government, in this clause is to ascertain how regular the company is in depositing statutory dues with the appropriate authorities. Since the emphasis of the clause is on the regularity, the scope of auditor’s inquiry is restricted to only those statutory dues, which the company is required to deposit regularly to an authority. The auditor is not required to ascertain whether the company is regular in depositing amounts, which may be levied by an appropriate authority from time to time upon occurrence or non-occurrence of certain events and therefore are not required to be paid regularly. Any sum, which is to be regularly paid to an appropriate authority under a statute (whether Central, State or Local or Foreign) applicable to the company, should be considered as a “statutory due” for the purpose of this clause. In other words, obligation to pay a statutory due is created or arises out of a statute, rather than being based on an independent contractual or legal relationship. Thus, examples of “statutory dues” would include municipal taxes, taxes deducted at source, fees payable to the licensing authority in respect of business being carried on under license granted by an authority, say a cinema hall. Accordingly, any sum payable to an electricity company as electricity bill would not constitute a statutory due despite the fact that such a company has been established under a statute. This is so because the due has arisen on account of contract of supply of goods or services between the parties. However, care shall have to be taken that in case any dues are recoverable as arrears of land revenue by the concerned authority, the same shall be treated as a statutory due.
- (d) With reference to regularity, it is also important to distinguish amongst the various items stated in the clause. The auditor should very clearly understand the nature of each statutory due payable by the company while examining the aspect of regularity before commenting on the same. For instance, the regularity is a normal feature in case of certain statutory dues such as, provident fund, employees’ state insurance, sales tax, etc., because the companies are required to deposit the money with appropriate authorities on a monthly or quarterly basis. But this is not the case in respect of, say, duty of custom on import of goods or demands arising on account of assessment orders etc., which a company is required to pay as and when an event giving rise to the liability of the company occurs. Such dues should be construed to

have been paid regularly if the company deposits them as and when they become due. However, the auditor would be required to comment upon the regularity of the company in depositing the installments, if any, granted by an authority in respect of a demand against the company.

- (e) An important issue to consider is the question of regularity of payment of import duty where the goods had been imported, say, five years back and were placed in the bonded warehouse and even till the end of the financial year under audit, the goods have not been removed from such warehouse. It may be noted that when the imported goods are lodged in a bonded warehouse, the payment of import duty is to be made when the goods are removed from the bonded warehouse. Till the time⁹ the importer opts to remove the goods from the warehouse, the importer is required to incur the rent and interest expenditure on the amount of customs duty payable. Since the payment of the custom duty is not due in the current case, the question of regularity does not arise in respect of custom duty. However, it may be noted that the interest and rent that are required to be incurred under section 61 of the Customs Act, 1962 would come under other statutory dues and the auditor would have to examine and comment upon the regularity of the company in depositing such interest and rent.
- (f) Non-payment of advance income tax would constitute default in payment of statutory dues. It may, however, happen that the company might not have any taxable income on the due dates on which advance tax is required to be paid. If such a company has an income after the last date on which the advance tax was required to be paid and consequently the company incurs interest under the relevant provisions of the Income Tax Act, 1961, it should not be construed that the company is not regular in depositing advance tax.
- (g) It may be noted that the auditor has to report on the regularity of deposit of statutory dues irrespective of the fact whether or not there are any arrears on the balance sheet date. This is because there may be situations where a company has deposited the relevant dues before the end of the year while it has been in default in the matter for a significant part of the year. In cases where there are no arrears on the balance sheet date but the company has been irregular during the year in depositing the statutory dues, the auditor should state this fact while reporting under this clause.
- (h) For the purpose of this clause, the auditor should consider a matter as “disputed”

⁹ It may be noted that section 61 of the Customs Act, 1962 provides that any goods deposited in the warehouse may be stored upto a period of one year in the bonded warehouse. The time limit is five years in case of capital goods and for other good three years which are intended for use in any 100% EOU. The said Act, however, also provides for extension of the warehousing period by the relevant authorities subject to certain prescribed conditions.

III.776 Auditing Pronouncements

where there is a positive evidence or action on the part of the company to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal. For this purpose, where an application for rectification of mistake (e.g., under section 154 of the Income Tax Act, 1961) has been made by the company, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of a statutory due is for a certain amount and the dispute relates only to a part and not the whole of such amount, only such amount should be treated as disputed and the balance amount should be regarded as undisputed. It is not necessary for the auditor to examine the sustainability or otherwise of the claim of the company regarding disputed amounts. It is sufficient for his purpose if the evidence available shows that the amount is disputed by the company. It may also be noted that the Order has clarified that mere representation to the concerned Department shall not be treated as a dispute.

- (i) A question may arise that when do the statutory dues become payable. There can be two views with regard to the question. On the one hand, it can be argued that the statutory dues referred to in this clause become payable on the last date by which payment can be made without attracting penalty and/or interest under the relevant law. On the other hand, it can also be argued that the amounts referred to in the clause become so payable as at the date of the expiry of the stay granted by the authorities or, where installments have been granted for the payment of statutory dues referred to in the clause, the date on which the default occurs and the amount becomes payable to the authorities. As the purpose of this clause is to indicate the amounts which have become actually payable and are outstanding as at the last day of the financial year concerned for a period of more than six months from the date they became payable, the latter view seems to conform more closely to the requirements of the Order.
- (j) It may be noted that penalty and/or interest levied under the respective laws would be covered within the term "amounts payable".
- (k) The report should be restricted to the actual arrears and should not include the amounts which have not fallen due for payment to appropriate authority and have been recognised as outstanding dues at the balance sheet date.
- (l) It is possible that in a large company where there are a number of departments with separate payrolls and where payments are spread over a number of days, the collection of data regarding the provident fund/employees' state insurance collections and the company's contribution thereto may take some time. In order to ensure that deposit of the dues is made in time, the company may make lump-sum deposits of estimated amounts and adjust the excess or deficit against the following month's deposit. If this method is consistently followed and the difference between the total dues and the lump-sum deposit is not significant, it need not be considered

that dues have not been regularly deposited and no unfavorable comment is necessary.¹⁰

Audit Procedures and Reporting

- (m) The auditor should make plans to test whether the company is regular in depositing undisputed statutory dues. The auditor, in order to be able to comment on this clause, should have a general understanding of the various statutes governing the company and the dues payable by the company under those statutes. The auditor should also enquire of the management of the company about the statutes under which the company is required to pay any statutory dues. The auditor should also discuss with the management, the policies or procedures adopted for identification and payment of statutory dues. The auditor may also obtain from the management or himself prepare a calendar of dates for submission of various statutory dues by the company for his reference.
- (n) The information necessary to comply with this requirement of the Order may be obtained from the company in the form of a statement. The statement should contain a list of various statutes under which the company is required to make payments regularly to appropriate authorities, the kind of payments under each statute, the due date for making the payment to the appropriate authority, the date on which the payment is made by the company, the arrears not due and the arrears overdue for more than six months. The auditor should verify the statement provided by the management with the underlying documents and records. The auditor's general understanding of the various statutes governing the company and the dues payable by the company under those statutes would help the auditor in assessing the completeness of the statement. The auditor should recognise that there could be a situation that a statutory due might have become payable but has not been captured by the accounting and internal control systems established by the enterprise and, therefore, the auditor should perform procedures to mitigate risk arising from such a situation.
- (o) The auditor should obtain a written representation with reference to the date of the balance sheet from the management:
 - (i) specifying the cases and the amounts considered disputed;
 - (ii) containing a list of the cases and the amounts in respect of the statutory dues which are undisputed and have remained outstanding for a period of more

¹⁰ The concept of materiality – which is fundamental to the entire auditing process – should be borne in mind while reporting on this clause as in case of other clauses of the Order.

III.778 Auditing Pronouncements

- than six months from the date they became payable; and
- (iii) containing a statement as to the completeness of the information provided by the management.
- (p) While the auditor has to report upon the regularity of the deposit, he is not required to specify in detail each instance where there has been a delay or the extent of the delay. It should be sufficient if he indicates whether generally the deposits have been regular or otherwise. The following are examples of the wordings, which may be used in relevant situations:
- (i) “undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess have been regularly deposited by the company with the appropriate authorities in all cases during the year”.
 - (ii) “undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess have generally been regularly deposited with the appropriate authorities though there has been a slight delay in a few cases”.
 - (iii) “undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess have not generally been regularly deposited with the appropriate authorities though the delays in deposit have not been serious”.
 - (iv) “undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess have not been regularly deposited with the appropriate authorities and there have been serious delays in a large number of cases”.
- (q) If the auditor is of the opinion that the company is not regular in depositing undisputed statutory dues including provident fund, employees’ state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, are required to be mentioned by the auditor in his audit report. In indicating the arrears, the period to which the arrears relate should also preferably be given and further, wherever possible, the fact of subsequent clearance or otherwise may also be indicated. The auditor may report in the following format:-

Statement of Arrears of Statutory Dues Outstanding for More than Six Months

Name of the Statute	Nature of the Dues	Amount (Rs.)	Period to which the amount relates	Due Date	Date of Payment	Remarks, if any
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43. Where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. {A mere representation to the concerned Department shall not be treated as a dispute.} [Paragraph 3(vii)(b)]

Relevant Provisions

- (a) This clause requires that in case of disputed statutory dues, the amounts involved should be stated along with the forum where the dispute is pending. Therefore, even minor amounts would be required to be reported under this clause. The amount should be reported in a manner so that the reader is able to understand the dispute and the amount involved therein.

Audit Procedures and Reporting

- (b) The audit procedures applied by the auditor for commenting on the previous clause, including obtaining a statement from the management in regard to the matters specified in the clause, would help the auditor in determining the dues of sales tax/income tax/duty of customs/service tax/duty of excise that have not been deposited on account of any dispute, the amounts involved and the forum where dispute is pending. The auditor should also obtain a management representation about the disputed dues, the amounts involved and the forum where the dispute is pending. The auditor should carry out necessary audit procedures to verify the information provided by the management.
- (c) A show-cause or similar notice generally contains the requirements/queries of the assessing officer. Normally, issuance of a show cause notice by the concerned department should not be construed to be a demand payable by the company. However, in some cases, a show cause notice and demand may be combined in one document. Normally, in such cases, the demand would not be construed to have arisen till the time the assessee has disposed off the requirements of the show cause order. Hence, it would be necessary to evaluate each situation individually.
- (d) Tax demands that have been set aside are clearly not 'dues'. Similarly, if a demand has been referred for reassessment and the effect of such referral is the

III.780 Auditing Pronouncements

cancellation of the earlier demand, this too would not constitute an amount due. The wording of the order would be of significance; if the demand is not cancelled, it will remain disputed dues. As far as demands that have been stayed are concerned, these should be regarded as disputed dues. These should be disclosed along with a disclosure of the fact of stay. The fact that a stay has been granted does not mean that the authority granting the stay has held that the amount in question is not a valid demand against the company. The stay normally is a concession that the amount may not be deposited immediately or that it may be deposited in installments. Sometimes a stay is granted if the assessee provides a bank guarantee. It may also be noted that there may be a situation that the appellate authority has decided a case in favour of the company but the Department may prefer to make an appeal to a higher authority. In such a case, there is considered to be no dispute until the time the Department makes an appeal to the relevant appellate authority. Further, in case where the amount under the dispute is pending for an appeal to be filed and the time limit for filing the appeal has lapsed, the disputed amount would become a statutory due and the reporting responsibilities of the auditor as are applicable to any other undisputed statutory due under clause 3(vii)(a) of the Order would become applicable. Further, in case where the amount under dispute has not been paid before filing the appeal and no appeal is filed within the time allowed and the time limit for filing the appeal has expired, the disputed amount would become a statutory due.

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

Statement of Disputed Dues

<i>Name of the Statute</i>	<i>Nature of the Dues</i>	<i>Amount (Rs.)</i>	<i>Period to which the amount</i>	<i>Forum where dispute is</i>	<i>Remarks, if any</i>
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			<i>relates</i>	<i>pending</i>	
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- (g) Further, a plain reading of the clause suggests that the amounts to be reported under clause 3(vii)(b) of the Order are those which have not been deposited on account of any dispute, irrespective of the treatment of such disputed amounts in accounts. It is quite possible that an amount is disputed and has not been deposited but on consideration of the likely outcome of the dispute, a provision has been made in the accounts. Such an amount will need to be reported, notwithstanding that it has been provided for. Similarly, even if it had not been provided for, it would have to be reported as long as it is not deposited. It is also possible that an amount is disputed, has been deposited and on consideration of the likely outcome of the dispute, has been shown as a recoverable. Though such an amount is not contemplated for reporting under the clause, since it has been deposited, the fact of such deposit having been made under protest should be brought out by the auditor in his report under the clause.

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

44. Whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided). [Paragraph 3(viii)]

Relevant Provisions

- (a) Under this clause, the auditor is required to report whether the company has defaulted in repayment of loans or borrowings¹¹ to a financial institution or bank or Government or dues to debenture holders. If the answer is in the affirmative, the auditor is also required to mention the period of default and the amount of default, lender wise.
- (b) A question that arises is whether the scope of the auditor's inquiry would cover defaults made by the company during the year only or whether the defaults committed in previous years and continuing until the year end would also be covered. It is clarified that the auditor should report the period and amount of all defaults existing at the balance sheet date irrespective of when those defaults have

¹¹ The term "Borrowings" has been explained in paragraph 18 of this Guidance Note.

III.782 Auditing Pronouncements

occurred.

- (c) Though the word “default” has not been defined, in this regard, the word “default” would mean non-payment of dues to banks, Government, financial institutions or debenture holders on the last dates specified in loan documents or debentures trust deed, as the case may be.

For example, in the case of term loans, fixed dates are prescribed for repayment in the agreement or terms and conditions of the loans. The dates prescribed for repayments would operate as the last date of payments and any delay after this fixed date would amount to default and reporting required in case of aggregate default on account of repayment of loan.

- (d) Section 2(39) of the Act defines “financial institution” to include a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934. Text of Section 45-I(c) of RBI Act, 1934 is given in **Appendix III** to this Guidance Note.

In view of the said definition, Financial Institution includes all Banks, Public Financial Institutions, as well as Non-Banking Institutions and also includes Non-Banking Financial Companies.¹²

- (e) This clause also requires reporting on default in repayment of loans or borrowings taken from the Government. The term “Government” means the department of the Central Government, a State Government and its department and a Union Territory and its department, but shall not include any entity, whether created by a statute or otherwise, the accounts of which are not required to be kept in accordance with article 150 of the constitution or the rules made there under. (As defined u/s 65B(26A) of the Finance Act 1994). Accordingly, the term “Government” does not include Government Company/ Public Sector Undertaking / Boards / Authority / Corporation and Foreign Government.

Audit Procedures and Reporting

- (f) The auditor should obtain the schedule of repayments to banks, financial institutions, government and debenture holders from the management of the company. The schedule should indicate the amount and the due dates of the payments that the company is required to make to banks, financial institutions, government and debenture holders.
- (g) The auditor should examine the agreement or other documents containing the terms and conditions of the loans and borrowings of the company taken from banks, Government and financial institutions. The auditor should also examine the

¹² Attention of the readers is invited to paragraphs 7 to 21 relating to applicability of the Order.

debenture trust deed. This examination would enable the auditor in verifying the amount and due dates of the payments mentioned in schedule of repayments provided by the management of the company. The auditor should then verify whether the repayments as per the books of account are in accordance with the terms and conditions of the relevant agreement.

- (h) The auditor should obtain the confirmation of the concerned bank or financial institution as to the status of the loan account including the overdue position as at the balance sheet date.
- (i) It may happen that the company might have submitted application for reschedulement/restructuring proposals to the lenders, which may be in different stages of processing. Submission of application for reschedulement/restructuring does not mean that no default has occurred. Accordingly, in such situations also the auditor should report the period of default and the amount of default. However, if the application for reschedulement of loan has been approved by the concerned bank or financial institution or if the default has been made good by the company during the year covered by the auditor's report, the auditor should state in his audit report the fact of reschedulement of loan or the fact of default having been made good.
- (j) It may be noted that for the purposes of reporting of default under this clause the term "borrowings" may be construed as the principal amount since it has been used in the context of the word "repayment" and the term "dues" would mean the principal and the interest.
- (k) The auditor may come across a situation where there may be disputes between the company and the lender on certain issues relating to repayments. In such situations, the auditor should consider the prevailing terms and conditions only. However, he may give a brief nature of the dispute while reporting under this clause.
- (l) Under this clause the auditor is required to give lender wise details in case of banks, financial institutions and Government only and not in respect of individual debenture holders and may incorporate the following details:-

Particulars	Amount of default as at the balance sheet date	Period of default	Remarks, if any.
i) Name of the Lenders: In case of:			

III.784 Auditing Pronouncements

Bank Financial Institution & Government			
ii) Debentures			

45. Whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported; [Paragraph 3(ix)]

Under this clause the auditor is required to report whether money raised by the company through Initial Public Offer or Further Public Offer (including debt instruments) and term loans have been utilised for the purposes for which those were raised.

Relevant Provisions

- (a) In case the company has made an Initial Public Offer or Further Public Offer (including debt instruments) the auditor is required to report upon the disclosure of end-use of the money by the management in the financial statements. The auditor is also required to state whether he has verified the disclosure made by the management in this regard. 'Securities' has been defined in Section 2(81) of the Act which refers to the definition of 'securities' in section 2(h) of the Securities Contracts (Regulation) Act, 1956. Initial public offer or further public offer shall cover issue of equity shares, convertible securities, non-convertible debt securities, non-convertible redeemable preference shares, perpetual debt instruments, perpetual non-cumulative preference shares, Indian depository receipts, and securitized debt instruments.
- (b) Part 1 of Chapter III of the Act consisting of Sections 23 to 41 deals with Public Offer. Section 23(1)(a) of the said Act, provides that, "a public company may issue securities to public through prospectus which is also referred to as "public offer". Explanation to Section 23 states that for the purpose of aforesaid Chapter III, the expression, "public offer" includes initial public offer or further public offer of securities to public by a company, or an offer for sale of securities to the public by an existing shareholder, through issue of prospectus. In terms of Section 24 of the said Act, the Securities & Exchange Board of India (SEBI) is empowered to regulate issue of securities by making regulations on that behalf. Therefore, a company raising moneys by way of Initial Public Offer or Further Public Offer shall have to follow the requirements of the applicable provisions of the Act, as well as the relevant SEBI Regulations.
- (c) Currently, there is no legal requirement under the Act to disclose the end use of money raised by Initial Public Offer or Further Public Offer (including debt

instruments) in the financial statements. The companies, however, make such a disclosure in the Board's Report. Schedule III to the Act requires that only unutilized amount of any Initial Public Offer or Further Public Offer (including debt instruments) made by the company should be disclosed in the financial statements of a company. In the absence of any legal requirement of such disclosure, it appears that the clause envisages that the companies should disclose the end use of money raised by the Initial Public Offer or Further Public Offer (including debt instruments) in the financial statements by way of notes and the auditor should verify the same.

Audit Procedures and Reporting

- (d) Normally, the companies do mention the end-use of the money proposed to be raised through the Initial Public Offer or Further Public Offer (including debt instruments) in the offer document. An examination of the offer document would provide the auditor an understanding of the proposed end-use of money raised from public. The auditor should verify that the amount of end-use of money disclosed in the financial statements by the management is not materially different from the proposed and actual end use. The auditor should obtain a representation from the management as to the completeness of the disclosure with regard to the end-use of money raised as well as actual end utilization of money raised by Initial Public Offer or Further Public Offer (including debt instruments). If, for any reason, the auditor is not able to verify the end-use of money raised from Initial Public Offer or Further Public Offer (including debt instruments), he should state that he is not able to comment upon the disclosure of end-use of money by the company since he could not verify the same. He should also mention the reasons which resulted in the auditor's inability to verify the disclosure.
- (e) It may be noted that while reporting under this clause, the auditor should also have regard to the SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015 (hereinafter referred as "LODR"), which contain a number of disclosure requirements in the balance sheet with respect to utilization of proceeds of monies raised from public, whether by shares or debentures, as also disclosure requirements in respect of unutilized monies from such proceeds. From a perusal of the LODR, it would be apparent that the details have to be given of both 'utilised' and 'unutilised' monies. Since the purpose is to provide a picture to the reader of 'utilisation of issue proceeds', it is only logical that the sum total of utilised and unutilised portions equal the total issue size. This implies that the figure of 'utilised' money should be cumulative.
- (f) It may also be noted that according to the LODR, the issuer company is required to make arrangements for the use of proceeds of the issue to be monitored by financial

III.786 Auditing Pronouncements

institutions. The monitoring agency so appointed is required to submit its report to the SEBI, on a half-yearly basis, till the completion of the project. In case, the company has appointed a monitoring agency for the purpose of the issue, reports of the monitoring agency would also be helpful to the auditor while reporting under the clause.

- (g) The expression “debt instrument” is neither defined in the Order nor under the Act. However, SEBI (Issue and Listing of Debt Securities), Regulations, 2008 which apply to public issue of debt securities and its listing, define the term “debt securities”. In terms of Regulation 2(1)(e) of the said regulations, it means a non-convertible debt securities which create or acknowledge indebtedness, and include debenture, bonds and such other securities of a body corporate or any statutory body constituted by virtue of a legislation, whether constituting a charge on the assets of the body corporate or not, but excludes bonds issued by Government or such other bodies as may be specified by the Board, security receipts and securitized debt instruments. Further, in terms of the Explanation to Section 23 of the Act, “Public Offer” would include ADRs and GDRs.
- (h) In view of the aforesaid, the reporting by an auditor as stated in paragraph (a) above should only relate to moneys raised by the company by way of initial public offer or further public offer of equity shares, convertible securities (defined above) and debt securities (defined above). Since, offer for sale of specified securities (i.e. equity shares and convertible securities) to the public by any existing holder does not result in any moneys raised in a company, the same is outside the purview of the reporting requirement under this clause. It seems that strictly in terms of the definitions of public offer, initial public offer and further public offer cited above, moneys raised from foreign capital markets and by way of issuance of Global Depository Receipts and American Depository Receipts may not fall within the scope of reporting under this clause.
- (i) This clause also requires the auditor to examine whether term loans were applied for the purpose for which these loans were obtained. First of all, the auditor should ascertain whether the company has taken any “term loans”. Term loans normally have a fixed or pre-determined maturity period or a repayment schedule. In the banking industry, for example, loans with repayment period beyond 36 months are usually known as “term loans”. Cash credit, overdraft and call money accounts/deposits are, therefore, not covered by the expression “term loans”. Term loans are generally provided by banks and financial institutions for acquisition of capital assets which then become the security for the loan, i.e., end use of funds is normally fixed.
- (j) The Order is silent as to whether this clause also covers term loans obtained from entities/persons other than banks/financial institutions. A strict interpretation of the

clause would mean that the term loan obtained from entities/persons other than banks/financial institutions would also have to be examined by the auditor for the purpose of reporting under the clause.

- (k) The auditor should examine the terms and conditions subject to which the company has obtained the term loans. The auditor may also examine the proposal for grant of loan made to the bank. As mentioned above, normally, the end use of the funds raised by term loans is mentioned in the sanction letter or documents containing the terms and conditions of the loan. The auditor should ascertain the purpose for which term loans were sanctioned. The auditor should also compare the purpose for which term loans were sanctioned with the actual utilisation of the loans. The auditor should obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised. If the auditor finds that the funds have not been utilized for the purpose for which they were obtained, the auditor's report should state the fact.
- (l) It is not necessary to establish a one-to-one relationship with the amount of term loan and its utilisation. It is quite often found that the amount of term loan disbursed by the bank is deposited in the common account of the company from which subsequently the utilisation is made. In such cases, it should not be construed that the amount has not been utilised for the purpose it was raised.
- (m) It may happen that the company might have acquired improved version/model of assets as against the assets for which the loan had been sanctioned. For example, if out of a loan sanctioned for purchase of machinery to be used for manufacture of shoe upper is instead used to purchase a machine, which apart from manufacturing shoe uppers has certain additional manufacturing facilities. In such cases, it should not be construed that the loan has not been applied for the purpose for which it was raised.
- (n) Normally, the term lenders directly make the payment to the vendors/suppliers. In such cases, it becomes easier for the auditor to comment on the application of term loans.
- (o) It may so happen that the term loans taken during the year might not have been applied for the stated purpose during the year, for example, the loan was disbursed at the fag end of the year. In such a case, the auditor should mention in his audit report that the term loan obtained during the year has not been utilised. This also implies that the auditor, while making inquiry in respect of this clause, should also consider the term loans which although were taken in the previous accounting period but have been actually utilised during the current accounting period.
- (p) In case of term loans, raised against title deeds, long term FDRs, NSCs etc., where the lender is not concerned with the purpose for which it is being obtained, the

III.788 Auditing Pronouncements

auditor should clearly mention the fact that in absence of any stipulation regarding the utilization of loans from the lender, he is unable to comment as to whether the term loans have been applied for the purposes for which they were obtained. In case the specific purpose is not recorded and the general purpose/ bone fide business use is stated; in such cases the auditor should verify whether the company has invested or utilized the money for purposes other than objects of the company.

- (q) During construction phase, companies, may, temporarily invest the surplus funds to reduce the cost of capital or for other business reasons. However, subsequently the same are utilised for the stated objectives. In such cases, the auditor should mention the fact that pending utilisation of the funds raised through Initial Public Offer or Further Public Offer (including debt instruments) or term loans for the stated purpose, the funds were temporarily used for the purpose other than for which they were raised but were ultimately utilised for the stated end-use.
- (r) Where the auditor concludes that the initial public offer or the further public offer (including debt instruments) or the term loans were not applied for the purpose for which the same were raised/obtained, the auditor should mention in his report that the amount involved as well as the nature of default including delay in utilization. The auditor is also required to report the details of any subsequent rectifications made by the company.
- (s) A suggested reporting format under this cause is as follows:

In our opinion and according to the information and explanations given to us, the Company has utilized the money raised by way of initial public offer/ further public offer (including debt instruments) and the term loans during the year for the purposes for which they were raised, except for:

Nature of the fund raised	Details of default (Reason /Delay)	Amount (Rs.)	Subsequently rectified (Yes/No) and details

46. Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated; [Paragraph 3(x)]

Relevant Provisions

- (a) This clause requires the auditor to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported

during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover such frauds. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds by the company or on the company by its Officer and employees that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements". In this context, the auditor should also have regard to the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013, issued by ICAI.

- (b) The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees including officers of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the "management fraud" can be construed as "fraud by the company".
- (c) Two types of intentional misstatements are relevant to the auditor's consideration of fraud - misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
- (d) Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:
 - (i) Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.

III.790 Auditing Pronouncements

- (ii) Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
 - (iii) Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
- (e) Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.
- (f) Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

Audit Procedures and Reporting

- (g) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.
- (h) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.
- (i) The auditor should obtain written representations from management that:
- (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and

- detect fraud and error;
- (ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;
 - (iii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and
 - (iv) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- (j) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."
- (k) The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.
- (l) Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:
- (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

III.792 Auditing Pronouncements

- (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
- (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

47. Whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the Company for securing refund of the same; [Paragraph 3(xi)]

Relevant Provisions

- (a) This clause requires the auditor to examine the compliance of Section 197 read with Schedule V of the Act, in respect of managerial remuneration paid or provided by the company and if not, then to report the amount involved along with the steps taken to secure refund of such amount. The text of section 197, the relevant extract of the Rules 4 & 5 of the Companies (Appointment & Remuneration of Managerial Personnel) Rules 2014 and Schedule V is reproduced in **Appendix VII** to this Guidance Note.

Audit Procedures and Reporting

- (b) Section 197 of the Act prescribes that the maximum ceiling for payment of managerial remuneration by a public company to its directors, including managing director and whole-time director and its manager which shall not exceed 11% of the net profit of the company in that financial year, computed in accordance with section 198 of the Act, except that the remuneration of the directors shall not be deducted from the gross profits.
- (c) It may be noted that section 197 applies only to a public company. The term “public company” has been defined under section 2(71) of the Act. Thereby, section 197 of the Act is not applicable to a Private Company, and, accordingly, reporting under this clause would not be required.
- (d) The term “Remuneration” under section 2(78) is defined to mean any money or its equivalent given or passed to any person for services rendered by him and includes perquisites as defined under the Income Tax Act, 1961. It may be noted that for the purposes of the Act, the term remuneration would include salaries, perquisites and commission on profits but would not include:
 - (i) Sitting fees paid to directors in accordance with the provisions of the Act (sub-sections 2 and 5 of Section 197).
 - (ii) Remuneration payable to directors for services rendered by him of a professional nature (sub-section 4 of Section 197).

- (e) The auditor's duty is to determine whether requisite approval mandated by the provisions of Section 197 read with Schedule V to the Act has been complied with:-
- (i) The overall managerial remuneration and requisite approval is summarized as under:-

S. No	Person entitled for remuneration	Maximum Remuneration in any financial year	If remuneration exceeds maximum remuneration in any financial year as provided under column (b)
	(a)	(b)	(c)
1.	Directors including managing director, whole time director and managers of public company (for all such directors and manager together)	11% of the net profits* of the company for that financial year	Company in general meeting with approval of Central Government subject to provisions of Schedule V may pay remuneration in excess of 11% of the net profits of the company.
2	One managing Director/ Whole time director/ manager	5% of the net profits* of the company for that financial year	With the approval of the company in general meeting this limit may be exceeded.
3	More than one managing Director/ Whole time director/ manager (for all such directors and manager together)	10% of the net profits* of the company for that financial year	With the approval of the company in general meeting this limit may be exceeded.
4	Directors who are neither managing director nor whole time directors	1% of the net profits* of the company, (if there is a Managing or whole time director or Manager) for that financial year. In any other case 3% of net profits.	With the approval of the company in general meeting this limit may be exceeded.

III.794 Auditing Pronouncements

*Net profits as computed in the manner referred to in section 198.

The above percentage will be exclusive of any fees (sitting fees) payable to the directors under Section 197(5) of the Act.

- (ii) Where remuneration (other than sitting fees) is paid in case company has no profits or inadequate profits, the same should be in accordance with the limits prescribed in section II of Part II of Schedule V to the Act by passing a resolution as prescribed and when there is no default in repayment of any of its debts (including public deposits) or debentures or interest thereon for a continuous period of thirty days in the preceding financial year before the appointment of such managerial personnel. The limit as prescribed shall be doubled if the resolution passed by the shareholder is a special resolution and passed in the manner prescribed complying with conditions specified in Schedule V itself. The auditor needs to examine the conditions prescribed including required disclosures in the financial statements and compliance of such provisions.
 - (iii) If the company pays remuneration to a managerial person in excess of the amounts in section II of Part II of schedule V, the approval from Central Government is also required in the manner prescribed in section III.
- (f) If the managerial remuneration has been paid or provided which is not in accordance with the requisite approval mandated by the provisions of section 197 read with Schedule V to the Act, the clause requires that the auditor should disclose the “amount involved” and report the steps taken by the company to secure refund of the same. Since the Order does not clarify what constitutes “amounts involved”, the same may be construed as meaning such amount of remuneration that has been paid or provided in excess of the limits prescribed under section 197 read with Schedule V of the Act. For this purpose, any amount that may have recovered or partially recovered by the company during the year would not be reduced from the “amount involved”.
- (g) Section 197(10) of the Act provides that without the permission of Central Government, the company shall not waive recovery of the excess amount paid over and above the prescribed limit. The auditor must examine the arrangement or agreements entered by the company in respect of securing refund of excess amount paid and should ask the management to give in writing, the steps which have been taken in this regard. The auditor should obtain sufficient appropriate audit evidence to support the fact that steps have been taken by the company for securing refund of the same.
- (h) The default may be reported incorporating the following details:-

- (i) Payment made to Director/ Whole time Director / Managing Director / Manager.
- (ii) Amount paid/ provided in excess of the limits prescribed.
- (iii) Amount due for recovery as at Balance Sheet date.
- (iv) Steps taken to secure the recovery of the amount.
- (v) Remarks, if any.

48. Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability; [Paragraph 3(xii)]

Relevant Provisions

- (a) This clause requires the auditor to report whether, in the case of a Nidhi Company, net-owned funds to deposit liability ratio is more than 1:20 and the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules 2014 to meet out the liability.
- (b) Section 406(1) of the Act defines “Nidhi” to mean a company which has been incorporated as a Nidhi with the object of cultivating the habit of thrift and savings amongst its members, receiving deposits from, and lending to, its members only, for their mutual benefit, and which complies with such rules as are prescribed by the Central Government for regulation of such class of companies.
- (c) It may be noted that Ministry of Corporate Affairs on 31st March 2014, vide its Notification No. GSR 258(E) notified the ‘Nidhi Rules 2014’, which came into force on the first day of April 2014. The said Rules are reproduced in the **Appendix VIII** to this Guidance Note. These Rules apply to Nidhi company incorporated as a Nidhi pursuant to the provisions of Section 406 of the Act and also to the Nidhi companies declared under sub-section (1) of section 620A of the Companies Act 1956.

Audit Procedures and Reporting

- (d) It may be noted that Rule 5(1) prescribes the requirements for minimum number of members, net owned fund etc. As per Rule 5(1) every Nidhi shall, within a period of one year from the commencement of these rules, ensure that it has—
 - (i) not less than two hundred members;
 - (ii) net owned funds of ten lakh rupees or more;

III.796 Auditing Pronouncements

- (iii) unencumbered term deposits of not less than ten per cent of the outstanding deposits as specified in Rule 14; and
- (iv) ratio of net owned funds to deposits of not more than 1:20.

The auditor should note that as such a Nidhi Company can accept deposits not exceeding twenty times of its net owned funds as per last audited balance sheet. Furthermore as per Rule 14, every Nidhi is to invest and continue to keep invested, in encumbered term deposits with a Scheduled commercial bank (other than a co-operative bank or a regional rural bank), or post office deposits in its own name an amount which shall not be less than ten per cent of the deposits outstanding at the close of business on the last working day of the second preceding month, which needs to be examined.

- (e) As per Rule 3(d) Net Owned Funds are defined as the aggregate of paid up equity share capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet:

Provided that, the amount representing the proceeds of issue of preference shares, shall not be included for calculating Net Owned Funds.

- (f) A Nidhi company can accept fixed deposits, recurring deposits accounts and savings deposits from its members in accordance with the directions notified by the Central Government. The aggregate of such deposits is referred to as "deposit liability".
- (g) The auditor should ask the management to provide the computation of the deposit liability and net owned funds on the basis of the requirements contained herein above. This would enable him to verify that the ratio of deposit liability to net owned funds is in accordance with the requirements prescribed in this regard. The auditor should verify the ratio using the figures of net owned funds and deposit liability computed in accordance with what is stated above. The comments of the auditor should be based upon such a statement provided by the management and verification of the same by the auditor.
- (h) The auditor may report, incorporating the following as at the balance sheet date:-
 - (i) In case of shortfall in the ratio of net owned funds to the deposits, report the amount of shortfall and state the actual ratio of net owned funds to the deposits.
 - (ii) In case of shortfall with regard to the minimum amount of 10% as unencumbered term deposits, as specified in Nidhi Rules 2014, report the amount thereof.

49. Whether all transactions with the related parties are in compliance with section 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards; [Paragraph 3(xiii)]

Relevant Provisions

- (a) The duty of the auditor, under this clause is to report:
- (i) Whether all transactions with the related parties are in compliance with section 177 and 188 of the Companies Act, 2013 (“Act”)
 - (ii) Whether related party disclosures as required by relevant Accounting Standards (AS 18, as may be applicable) are disclosed in the financial statements
- (b) Section 188 of the Act is applicable to all classes of companies (including private companies). The Act envisages the approval of Board of Directors and/or the approval of the shareholders (by way of resolution passed in the general meeting of the company), as the case may be, in accordance with the provisions of section 188. However:-
- (i) approval of shareholders by way of resolution is not required for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.
 - (ii) approval of the Board of Directors and shareholders is not required in respect of related party transactions entered into by the company in its ordinary course of business and on an arm’s length basis.
- (c) The Related Party, with reference to a company is defined in section 2(76) of the Act. The transactions which are covered by section 188 are:
- (i) sale, purchase or supply of any goods or materials;
 - (ii) selling or otherwise disposing of, or buying, property of any kind;
 - (iii) leasing of property of any kind;
 - (iv) availing or rendering of any services;
 - (v) appointment of any agent for purchase or sale of goods, materials, services or property;

III.798 Auditing Pronouncements

- (vi) related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and
 - (vii) Underwriting the subscription of any securities or derivatives thereof, of the company.
- (d) Explanation (b) to Section 188(1) defines 'arm's length transaction' to mean a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest. Standard on Auditing (SA) 550, "Related Parties" defines arm's length transaction as "a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interest." The decision as to whether a transaction is at an arm's length or not would need considering several factors such as benefits/ consideration for each of the parties to enter into the agreement, the prevalent market/industry practice, economic circumstances, the specific contractual understanding and / or terms between the parties, similar contracts executed between other unrelated parties, etc. For the purpose of this Clause the auditor may test the transaction of arm's length basis based on the transfer pricing mechanism in use for the purposes of Income Tax Act, 1961.
- (e) The phrase 'ordinary course of business' is not defined under the Act. It seems that the ordinary course of business will cover the usual transactions, customs and practices of a business and of a Company. In many cases, it may be obvious that a transaction is in the 'ordinary course of business.' For example, a car manufacturing company sells a car to its group company. The price charged for the sale is the same as what it charges to other corporate customers who are unrelated parties. In this case, one may be able to conclude, without much difficulty, that the transaction has been entered into by the company in its ordinary course of business. Similarly, in certain extreme cases, it may be clear that the transaction is highly unusual and/ or extraordinary from the perspective of the company as well as its line of business. Hence, it may not be construed as being in the 'ordinary course of business. SA 550, "Related Parties" (Paragraph A25) has listed certain examples of transactions outside the entity's normal course of business:
- (i) Complex equity transactions, such as corporate restructurings or acquisitions.
 - (ii) Transactions with offshore entities in jurisdictions with weak corporate laws.
 - (iii) The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
 - (iv) Sales transactions with unusually large discounts or returns.

- (v) Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- (vi) Transactions under contracts whose terms are changed before expiry.
- (f) The above examples are just illustrative and are not conclusive for the purposes of analysis under the Act. However, it provides some indicators based on which one may consider following aspects while performing evaluation of 'ordinary course of business':
 - (i) Whether the transaction is covered in the objects of the company as envisaged in the Memorandum of Association;
 - (ii) Whether a transaction is usual or unusual, both from the company and its line of business perspective;
 - (iii) Frequency: If a transaction is happening quite frequently over a period of time, it is more likely to be treated as an ordinary course of business. However, the inverse does not necessarily hold true;
 - (iv) Whether transaction is taking place at arm's length;
 - (v) Business purpose of the transaction;
 - (vi) Whether transaction is done on similar basis with other third parties; and
 - (vii) Size and volume of transaction.

The assessment of whether a transaction is in the ordinary course of business is likely to be very subjective, judgmental and will vary on case-to-case basis. The factors mentioned above may help in making this assessment.

Audit Procedures and Reporting

- (g) The auditor should obtain written representations from management and, where appropriate, those charged with governance that:
 - (i) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
 - (ii) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.
- (h) Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

III.800 Auditing Pronouncements

- (i) When they have approved specific related party transactions that
 - a) materially affect the financial statements, or
 - b) involve management.
 - (ii) When they have made specific oral representations to the auditor on details of certain related party transactions.
 - (iii) When they have financial or other interests in the related parties or the related party transactions.
 - (iv) Management's assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction.
- (i) The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.
 - (j) The auditor should obtain a list of companies, firms or other parties, the particulars of which are required to be entered in the register maintained under section 189 of the Act. The auditor should verify the entries made in the register maintained under section 189 of the Act from the declarations made by the directors in Form MBP-1 i.e., general notice received from a director under Rule 9(1) of the Companies (Meetings of Board and Power) Rules, 2014. The auditor should also obtain a written representation from the management concerning the completeness of the information so provided to the auditor. The auditor should review the information provided by the management. The auditor should also perform the following procedures in respect of the completeness of this information:
 - (i) review his working papers for the prior years, if any, for names of known companies, firms or other parties the particulars of which are required to be entered in the register maintained under section 189 of the Act; and
 - (ii) review the entity's procedures for identification of companies, firms or other parties the particulars of which are required to be entered in the register maintained under section 189 of the Act.
 - (k) A difficulty in judging the arm's length of prices may also arise in cases where transactions are entered with sole suppliers. In such cases, the auditor may examine the prices paid with reference to list prices of the supplier concerned, other trade terms of the supplier, etc. It may be noted that the Company while determining whether the transactions entered into by it in its ordinary course of business with its

related parties are on an arm's length basis must have documentary proof of same while entering into the transaction.

- (l) Section 177(4)(iv) of the Act requires that audit committee (of every listed companies and other classes of companies which is required to constitute audit committee) to approve transactions of the company with related parties.
- (m) The auditor is required to perform appropriate procedures to satisfy himself as regards compliance with section 177 and 188 of the Act so that auditor is able to appropriately report under this clause. Auditor can refer SA 550, "Related Parties" which has prescribed auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements, including guidance on the procedures to be performed by auditors. The key aspects of SA 550 which would be relevant for reporting on this clause are:
 - (i) Identified significant related party transactions outside the entity's normal course of business, detailed guidance is available in paragraph A38 to A41 of SA 550.
 - (ii) Assertions that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction, detailed guidance is available in paragraph A42 to A45 of SA 550.
 - (iii) Evaluation of the accounting for and disclosure of identified related party relationships and transactions, detailed guidance is available in paragraph A46 to A47 of SA 550.
- (n) A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions.
- (o) Based on the procedures performed by the auditor, if auditor comes across any non-compliance, then, it should be duly reported. The following particulars may be incorporated:

Nature of the related party relationship and the underlying transaction	Amount involved (Rs.)	Remarks (<i>details of non-compliance may be given</i>)

III.802 Auditing Pronouncements

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50. Whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of Section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance; [Paragraph 3(xiv)]

Relevant Provisions

- (a) This clause requires that in case of private placement of shares or fully or partly convertible debentures, during the year under review, whether the requirements of section 42 of the Act and the Rules framed thereunder have been complied with. Further this clause also requires the auditor to report upon the utilization of the said funds for the purposes for which it has been raised, if not, the reporting is required giving details of the amount involved and nature of non-compliance.

Audit Procedures and Reporting

- (b) (i) The term 'Private Placement' has been defined under the Explanation (ii) to section 42(2) to mean any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in section 42 of the Act. In addition, the provisions of Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 also need to be complied with while reporting under this clause.

The text of Section 42 of the Act and Rule 14 of the Companies (Prospectus & Allotment of Securities) Rules, 2014 are reproduced in **Appendix IX** and **Appendix X** to this Guidance Note.

- (ii) It may be noted that the term "preferential allotment" is not defined under the Act. Further this clause specifically relates to the compliance under section 42 of the Act only with respect to equity shares, preference share and fully or partly convertible debenture issued. The auditor needs to examine the compliance of the requirements of section 42 of the Act which deals with the private placement.
- (c) Section 42 of the Act requires, *inter alia*, as under:

- (i) Such private placement, i.e., offer of securities or invitation to subscribe securities should be made to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter.

The offer of securities or invitation to subscribe securities shall be made to such number of persons not exceeding two hundred, [excluding qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option as per provisions of clause (b) of sub-section (1) of section 62], in a financial year and on such conditions (including the form and manner of private placement) as may be prescribed.

Qualified institutional buyer means as defined in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009. Section 42 provides maximum number of persons 50 or higher number which is prescribed by rule 14 of the Companies (Prospectus & Allotment of Securities) Rules, 2014 as 200 persons.

- (ii) If a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than the prescribed number of persons, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognised stock exchange in or outside India, the same shall be deemed to be an offer to the public and shall accordingly be governed by the provisions of Public offer.
- (iii) No fresh offer or invitation of private placement shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.
- (iv) Any offer or invitation not in compliance with the provisions of section 42 of the Act shall be treated as a public offer and respective provisions of the Act, the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be required to be complied with.
- (v) All monies payable towards subscription of securities under section 42 of the Act shall be paid through cheque or demand draft or other banking channels but not by cash.
- (vi) A company making an offer or invitation on private placement shall allot its securities within sixty days from the date of receipt of the application money for such securities and if the company is not able to allot the securities within that period, it shall repay the application money to the subscribers within fifteen days from the date of completion of sixty days and if the company fails

III.804 Auditing Pronouncements

to repay the application money within the aforesaid period, it shall be liable to repay that money with interest at the rate of twelve percent per annum from the expiry of the sixtieth day.

- (vii) Also monies received on application under private placement shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than (a) for adjustment against allotment of securities; or (b) for the repayment of monies where the company is unable to allot securities.
 - (viii) All offers covered under section 42 of the Act shall be made only to such persons whose names are recorded by the company prior to the invitation to subscribe, and that such persons shall receive the offer by name, and that a complete record of such offers shall be kept by the company in such manner as may be prescribed and complete information about such offer shall be filed with the Registrar within a period of thirty days of circulation of relevant private placement offer letter.
 - (ix) No company offering securities under section 42 of the Act shall release any public advertisements or utilise any media, marketing or distribution channels or agents to inform the public at large about such an offer.
 - (x) The company making any allotment of securities under section 42 of the Act shall file with the Registrar a return of allotment in such manner as may be prescribed, including the complete list of all security-holders, with their full names, addresses, number of securities allotted and such other relevant information as may be prescribed.
 - (xi) If a company makes an offer or accepts monies in contravention of section 42 of the Act and an order imposing the penalty for such contravention is passed, then the company shall also refund all monies to subscribers within a period of thirty days of the order imposing the penalty.
- (d) In case the requirements of section 42 of the Act and rules framed in this regard are not complied with, the auditor should report incorporating following details:

Nature of securities viz. Equity shares/ Preference shares/ Convertible debentures	Amount Involved	Nature of non-compliance

- (e) This clause also requires the auditor to examine whether funds so raised from private placement of shares or fully or partly convertible debentures were applied for the purpose for which these securities were issued. The examination of auditor

may cover following aspects:

- (i) Paragraph 2(i) of the Form PAS-4, Private Placement Offer Letter¹³, requires the company to provide particulars in respect of the purposes and objects of the offer. Accordingly, the auditor should compare such information provided by the Company in Form PAS-4 with the actual utilization of the monies as per the books of account of the Company.
 - (ii) It is not necessary to establish a one-to-one relationship with the amount of fund raised and its utilisation. It is quite often found that the amount of fund raised is not deposited in a separate bank account of the company from which subsequent utilisation is made. In such cases, it should not be construed that the amount has not been utilised for the purpose for which it was raised.
 - (iii) During construction phase, companies may temporarily invest the surplus funds prudently. However, subsequently the same are utilised for the stated objectives. In such cases, the auditor should mention the fact that pending utilisation of the fund raised for the stated purpose, the funds were temporarily used for the purpose other than for which the funds was raised.
 - (iv) However if the funds were ultimately utilised for the stated end-use, the reporting for the same may be made as and when the same have been utilized.
 - (v) It may so happen that the funds raised during the year might not have been applied for the stated purpose during the year, for example, the funds were raised at the fag-end of the year. In such a case, the auditor should mention in his audit report that the funds raised during the year has not been utilised. This also implies that the auditor, while making inquiry in respect of this clause, should also consider that the funds raised, which were raised in the previous accounting period but have been actually utilised during the current accounting period.
 - (vi) In case the specific purpose is not recorded and the general purpose/*bona-fide* business use etc., are stated then in such cases, auditor should verify that the company has invested or utilized the money for general purpose/*bona-fide* business use of the company.
- (f) The auditor may report the non-compliances incorporating the following details:

¹³ Prescribed in the Companies (Prospectus of Securities) Rules, 2014.

III.806 Auditing Pronouncements

Nature of Securities viz. Equity shares /Preference shares /Convertible debentures	Purpose for which funds raised	Total Amount Raised /opening un-utilized balance	Amount utilized for the other purpose	Un-utilized balance as at Balance sheet date	Remarks, if any

51. Whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with; [Paragraph 3(xv)]

Relevant Provisions

- (a) Section 192 of the Act deals with restriction on non-cash transactions involving directors or persons connected with them. The section prohibits the company from entering into following types of arrangements unless it meets the conditions laid out in the said section:
- (i) An arrangement by which a director of the company or its holding, subsidiary or associate company or a person connected with such director acquires or is to acquire assets for consideration other than cash, from the company.
 - (ii) An arrangement by which the company acquires or is to acquire assets for consideration other than cash, from such director or person so connected.
- (b) Arrangements, as discussed herein above, can only be entered by the company on fulfillment of the conditions laid out in Section 192 of the Act which are as under:
- (i) The company should have obtained prior approval for such arrangement through a resolution of the company in general meeting.
 - (ii) In case the concerned director or the person connected therewith, is also a director of its holding company, a similar approval should have been obtained by the holding company through a resolution at its general meeting.
- (c) The reporting requirements under this clause are in two parts. The first part requires the auditor to report on whether the company has entered into any non-cash transactions with the directors or any persons connected with such director/s. The second part of the clause requires the auditor to report whether the provisions of section 192 of the Act have been complied with. Therefore, the second part of the clause becomes reportable only if the answer to the first part is in affirmative.

- (d) In other words, such transactions involving change in the assets or liabilities of a company but not involving “cash” or cash equivalents” as defined under Accounting Standard (AS) 3, “Cash Flow Statement” may be construed as non-cash transactions. At this point, it may be appropriate to also refer to the definition and discussion on “non-cash transactions” & “cash and cash equivalents”, as given in AS 3.
- (e) There may be a situation where the acquisition of the asset takes place in one year and the corresponding liability is created in the financial statements, the corresponding settlement in the following year. The said transaction will not be considered as non-cash transaction. Further, mergers under Court schemes would be entered into subject to requisite approvals of Court etc., would not be considered non-cash transactions.
- (f) The term “person connected with the director” has not been defined in the Act, or the Rules thereunder. Instead, the term “to any other person in whom the director is interested” is defined in the Explanation to sub section (1) of section 185 of the Act, which is reproduced as under and may be used as the reference point for reporting under this clause.
- “(a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;
- (b) any firm in which any such director or relative is a partner;
- (c) any private company of which any such director is a director or member;
- (d) any body corporate at a general meeting of which not less than twenty-five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or
- (e) any body corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.”
- (g) Section 2(77) of the Companies Act, 2013 read with Rule 4 of the Companies (Specification of Definition Details) Rules, 2014 defines the term “relative”. As per the aforesaid section 2(77),
- “Relative, with reference to any person, means anyone who is related to another, if–*
- (i) *they are members of a Hindu Undivided Family;*
- (ii) *they are husband and wife; or*
- (iii) *one person is related to the other in such manner as may be prescribed”*

III.808 Auditing Pronouncements

As per Rule 4 of the Companies (Specification of Definition Details) Rules, 2014, a person shall be deemed to be the relative of another, if he or she is related to another in the following manner, namely –

- (i) Father, including step father
 - (ii) Mother, including step mother
 - (iii) Son, including step son
 - (iv) Son's wife
 - (v) Daughter
 - (vi) Daughter's husband
 - (vii) Brother, including step brother
 - (viii) Sister, including step sister
- (h) The term “acquire” simply means to come into possession of something. A thing that cannot be sold cannot be acquired¹⁴. Thus, an acquisition would necessarily involve existence of two parties and a transfer of rights and/or obligations in a thing. In the context of section 192 of the Act, this transfer is between the company and the director and/or a person connected with a director. Such “director” is not restricted to being a director of the concerned company, but extends to director of a holding company, subsidiary or associate of the company under question.
- (i) As provided in section 192, the acquisition by/from the company has to be that of an “asset”. Further, the term assets should be construed to have the same meaning as described in the Framework for Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India. The auditor would need to evaluate whether the subject matter of acquisition by/ from the company satisfies the characteristic of an “asset”.

Audit Procedures and Reporting

- (j) For reporting on the first leg of the reporting clause, the starting point of the auditor's procedures could be obtaining a management representation as to whether the company has undertaken any non-cash transactions with the directors or persons connected with the directors, as envisaged in section 192(1) of the Act. The auditor would need to corroborate the management representation with sufficient appropriate audit evidence. A scrutiny of the following books of account, records and documents could provide source of such audit evidence to the auditor as to the existence of such non cash transactions as well as persons connected with the

¹⁴ Acquire. (n.d.) *A Law Dictionary, Adapted to the Constitution and Laws of the United States*. By John Bouvier(1856). Retrieved March 26, 2016 from <http://legal-dictionary.thefreedictionary.com/acquire>.

Directors:

Persons connected with Director	Acquisition by/ From Company
Form No. MBP 1, <i>Notice of Interest by Director</i> , filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014 [Ref: Sec 184(1) and Rule 9(1)]	Form No. MBP 2, <i>Register of Loans, Guarantee, Security and Acquisition Made by the Company</i> , filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014 [Ref: Sec 186(9) and Rule 12(1)]
	Form No. MBP 4, <i>Register of Contracts with Related Party and Contracts and Bodies etc in which Directors are Interested</i> , filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014 [Ref: Sec 189(1) and Rule 16(1)]
	Movements in the Fixed Asset Register
	Minutes book of the General Meeting and Meetings of Directors
	Report on Annual General Meeting pursuant to Companies (Management and Administration) Rules, 2014 {Ref Sec 121(1) and Rule 31(2)}

- (k) The above documents and records would provide evidence of any such non-cash transactions that have actually taken place. The language of section 192(1) also uses the term “is to acquire” in the context of such transactions, indicating the existence of intention to acquire. The management may be requested to provide details of its intention to enter into transactions covered under section 192, after the date of the financial statements under audit. The minutes of the meetings of the Board of Directors and the Audit Committee may provide evidence of such intention.

III.810 Auditing Pronouncements

Besides, a scrutiny of the information for subsequent period as contained in the aforesaid records and documents may provide corroborative audit evidence of such intention having existed as at the date of the auditor's report.

- (l) Where the company has entered into/is to enter into any non-cash transactions as discussed above, the auditor would make a report to that effect under this clause. The second leg of the clause requires the auditor to report whether the Company has complied with the provisions of section 192 in this regard. Section 192(1) and (2) envisage the following compliances in respect of such transactions:
 - (i) The company should have obtained a prior approval for such arrangement by a resolution in the General Meeting.
 - (ii) If the concerned Director or connected person is a director of the company's holding company, the latter too should have obtained a similar prior approval for the arrangement by a resolution at its General Meeting.
 - (iii) Notice for approval of the resolution should contain details of the arrangement along with the value of assets involved duly calculated by a registered valuer.

The auditor should check compliance with Section 192(2) and verify the notice of the General Meeting that it includes particulars of arrangement along with the value of the assets involved such arrangements. The said value should be calculated by the register valuer.

- (m) In case where the concerned director/connected person is also a director of the holding company, the auditor would need to check whether the holding company has complied with the requirements. For this purpose, the auditor would need to obtain a management representation letter from the holding company through the management of the auditee company.

Suggested paragraph on reporting:

According to the information and explanations given to us, the Company has entered into non-cash transactions with one of the directors/ person connected with the director during the year, by the acquisition of assets by assuming directly related liabilities, which in our opinion is covered under the provisions of Section 192 of the Act, and for which approval has not yet been obtained in a general meeting of the Company.

52. Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained. [Paragraph 3(xvi)]

Relevant Provisions

- (a) The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company.
- (b) The Reserve Bank of India restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration. The relevant Text of the Section 45-IA is reproduced in **Appendix XI** to this Guidance Note.
- (c) A Non-Banking Financial Company (NBFC) is a company registered under the Act, engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

- (d) What does conducting financial activity as “principal business” mean? The response to an FAQ as given by Reserve Bank of India required to be considered while examining the requirement of registration:-

“Financial activity as principal business is when a company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term 'principal business' is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable

III.812 Auditing Pronouncements

property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as 50-50 test and is applied to determine whether or not a company is into financial business. (As per FAQ response of question - What does conducting financial activity as “principal business” mean? <https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92>)”

- (e) NBFCs are doing functions similar to banks, however there exist difference between banks & NBFCs. NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:
- (i) NBFC cannot accept demand deposits;
 - (ii) NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
 - (iii) deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

(As per FAQ response of question NBFCs are doing functions similar to banks. What is difference between banks & NBFCs?

<https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92>)”

- (f) As per Reserve Bank of India Act, 1934 Section 45I Clause (c) any company carries on as its business or part of its business any activity considered as carrying on the business of Financial Institution. The relevant text of the Section 45I(c) is reproduced in **Appendix III** to this Guidance Note.
- (g) Further Section 45-I Clause (f) of the Reserve Bank of India Act, 1934 defines the Non-Banking Financial Company reproduced in **Appendix III** to this Guidance Note.
- (h) The Reserve Bank of India defined “net owned fund” as (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting there from (i) accumulated balance of loss; (ii) deferred revenue expenditure; and (iii) other intangible assets; and (b) further reduced by the amounts representing– (1) investments of such company in shares of– (i) its subsidiaries; (ii) companies in the same group; (iii) all other non-banking financial companies; and (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,– (i) subsidiaries of such company; and (ii) companies in the same group, to the extent such amount exceeds ten per cent of (a) above. (“Subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.)

Audit Procedures and Reporting

- (i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.
- (j) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.
- (k) Whether the company has net owned funds as required for the registration as NBFC.
- (l) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.
- (m) The auditor should report incorporating the following:-
 - (i) Whether the registration is required under section 45-IA of the RBI Act, 1934.
 - (ii) If so, whether it has obtained the registration.
 - (iii) If the registration not obtained, reasons thereof.

Comments on Form of Report

53. The Order requires that the auditor should make a statement on all such matters contained therein as are applicable to the company. The Order further provides that where an auditor is unable to express any opinion, he should indicate such fact. The auditor is also required to give reasons for any unfavourable or qualified answer. Further, where the auditor is unable to express an opinion on any such matter which is applicable to the company, he is also required to indicate in his report such fact together with the reasons as to why he is unable to express any opinion.

54. A question may also arise whether it is necessary for the auditor to include in his report the management's explanation for any matter on which he makes an unfavourable comment. Normally, such an explanation need not be included but there may be circumstances where the auditor feels such inclusion is necessary. Examples of such circumstances would be:

- (a) to make the comment itself more meaningful and complete. For example, physical verification of inventories, though planned, may not have been carried out because of a strike or a lockout. An unfavourable comment without this explanation would be misleading;
- (b) to explain the fact why in spite of an unfavourable comment, the true and fair view of

III.814 Auditing Pronouncements

the financial statements is not vitiated. For example, physical verification of a part of the inventories at the year-end may not have been carried out, but there is sufficient other evidence produced by the management which satisfies the auditor regarding the existence, condition and value of the inventories.

55. If any of the comments on matters specified in the Order are adverse, the auditor should consider whether his comments have a bearing on the true and fair view presented by the financial statements and, therefore, might warrant a modification in the report under sub-sections (2), (3) and (4) of section 143.

56. If the auditor is of the opinion that any of the unfavourable comments on matters specified in the Order results in a qualification under sub-sections (2) and (3) of section 143 the manner of reporting would have to be in accordance with the principles enunciated in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

57. Even where there are no unfavourable comments under the Order, it may be advisable for the auditor to preface his report under sub-sections (2) and (3) of section 143 with the words:

"Further to our comments in the Annexure, we state that....."

58. It should not, however, be assumed that every unfavourable comment under the Order would necessarily result in a qualification in the report under sub-sections (2) and (3) of section 143. Firstly, the unfavourable comment may be regarding a matter which has no relevance to a true and fair view presented by the financial statements, for example, the failure of the company to deposit provident fund dues in time or to comply with the requirements regarding acceptance of deposits. Secondly, while the non-compliance may be material enough to warrant an unfavourable comment under the Order, it may not be material enough to affect the true and fair view presented by the financial statements. Finally, the non-compliance may be in an area which calls for remedial action on the part of the management, and may be important for that reason but may not be sufficiently important in the context of the report under sub-sections (2) and (3). In deciding, therefore, whether a qualification in the report under sub-sections (2) & (3) is necessary, the auditor should use his professional judgement in the facts and circumstances of each case.

59. Where there is an unfavourable comment both under sub-section (1) of section 143 of the Act and under the Order, it is suggested that the qualification under sub-section (1) precede the qualification under the Order.

60. It is important to note that replies to many of the requirements of the Order will involve expression of opinion and not necessarily statement of facts. It is necessary, therefore, that this is indicated when making the report under the Order. This can be done in either of the following ways:

(a) By a general preface to the comments under the Order on the following lines:

“In terms of the information and explanations sought by us and given by the company and the books and records examined by us in the normal course of audit and to the best of our knowledge and belief, we state that.....”

or

- (b) by a preface to individual comments, for example,
“In our opinion” or “In our opinion and according to the information and explanations given to us during the course of the audit...”

61. The Order requires that where the answer to a question is unfavourable or qualified, the auditor’s report should also state the reasons for such unfavourable or qualified answer. While it is not necessary for the auditor to give very detailed reasons for an unfavourable or qualified answer, he is expected to explain the general nature of the qualification or adverse comment in clear and unambiguous terms.

62. Similar considerations would apply when the auditor is unable to express an opinion. In such circumstances, he should clearly state that he is unable to express an opinion because such records or evidence have not been produced before him.

63. In expressing an opinion, the auditor should be quite clear as to whether the circumstances of the case warrant a negative answer or whether his opinion can be expressed subject to a qualification.

64. The auditor’s report under sub-section (3) of section 143 is required to state whether the auditor has sought and obtained all the information and explanations which to the best of his knowledge and belief, were necessary for the purposes of his audit and if not, the details thereof and the effect of such information on the financial statements. The term “audit” would include the reporting requirements under the Order. Therefore, when making his report, the auditor has to consider whether he has sought and obtained the information and explanations needed not merely for the purposes of normal audit, but also for the purpose of reporting in terms of the Order. If he has sought but not received the information and explanations necessary for reporting in terms of the Order, he should mention that fact both when reporting on the specific question in the Order and also consider the impact of such non receipt of the information on the auditor’s report under section 143(3)(a) of the Act.

Board’s Report

65. Section 134(3)(f) of the Act requires that the board of directors shall be bound to give in its report the fullest information and explanations regarding every reservation, qualification or adverse remark or disclaimer contained in the auditor’s report. The auditor’s comments in terms of the Order form part of his report and, therefore, the Board

III.816 Auditing Pronouncements

will be bound to give in its report the fullest information and explanations regarding every unfavourable comment or qualification therein.

66. The auditor's comments in terms of the Order may be in respect of matters of fact or they may be an expression of opinion. It is necessary that there should be no inconsistency in the facts as stated by the auditor and as explained in the board's report. It is, therefore, suggested that wherever possible, a draft report should be submitted to the Board to verify and confirm the facts stated therein.

67. It is, however, possible that, on the same facts, there may be a genuine difference of opinion between the auditor and the Board. In such a case, each is entitled to hold his or its view. Therefore, the expression of a different opinion in the Board's report should not be regarded as any reflection on the opinion expressed by the auditor.

Appendix I

Text of the Companies (Auditor's Report) Order, 2016

MINISTRY OF CORPORATE AFFAIRS

ORDER

New Delhi, the 29th March, 2016

S.O 1228(E).—In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013) and in supersession of the Companies (Auditor's Report) Order, 2015 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 990 (E), dated the 10th April, 2015, except as respects things done or omitted to be done before such supersession, the Central Government, after consultation with the, committee constituted under proviso to sub-section (11) of section 143 of the Companies Act, 2013 hereby makes the following Order, namely:—

1. **Short title, application and commencement.**- (1) This Order may be called the Companies (Auditor's Report) Order, 2016.

(2) It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 (18 of 2013) [hereinafter referred to as the Companies Act], except—

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) a company licensed to operate under section 8 of the Companies Act;

- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

2. Auditor's report to contain matters specified in paragraphs 3 and 4. - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

Provided the Order shall not apply to the auditor's report on consolidated financial statements.

3. Matters to be included in the auditor's report. - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
(c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;

III.818 Auditing Pronouncements

- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
 - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
 - (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
- (v) in case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed thereunder, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
- (vi) whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.
- (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
 - (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).
- (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, government or dues to debenture holders? If yes, the

period and the amount of default to be reported (in case of defaults to banks, financial institutions, and government, lender wise details to be provided).

- (ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
- (xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;
- (xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (xiii) whether all transactions with the related parties are in compliance with section 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;
- (xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;
- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

III.820 Auditing Pronouncements

4. Reasons to be stated for unfavourable or qualified answers.- (1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.

(2) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

[F. No. 17/45/2015-CL-V]

AMARDEEP SINGH BHATIA, Jt. Secy

Appendix II

Clause-by-clause comparison of the reporting requirements of the Order and the erstwhile CARO 2015

1. Short title, application and commencement. -

- (1) This order may be called the Companies (Auditor's Report) Order, 2016.
- (2) It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 (18 of 2013) [hereinafter referred to as the Companies Act], except -
 - (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
 - (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
 - (iii) a company licensed to operate under section 8 of the Companies Act;
 - (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act, and a small company as defined under clause (85) of section 2 of the Companies Act, 2013; and
 - (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year; and which does not have a total revenue as disclosed in Schedule III to the Companies Act, 2013

(including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

2. Auditor's report to contain matters specified in paragraphs 3 and 4. - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him to which this Order applies for the financial year commencing on or after 1st April, 2015, shall contain the matters specified in paragraphs 3 and 4.

Provided the Order shall not apply to the auditor's report on consolidated financial statements.

3. Matters to be included in the auditor's report. - The auditor's report on the account of a company to which this Order applies shall include a statement on the following matters, namely:

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
(c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof.
- (ii) (a) whether physical verification or inventory has been conducted at reasonable intervals by the management
and whether any material discrepancies were noticed and if so, whether the same have been properly dealt with in the books of account;
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, limited liability partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
 - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
 - (b) whether the schedule of repayment the principal and payment of interest has been stipulated and whether repayments or receipts are regular; (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

III.822 Auditing Pronouncements

- (iv) in respect of loans, investments, guarantees and security whether provisions of section 185 and 186 of the Companies Act 2013 have been complied with. If not, provide the details thereof.
- (v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules framed there under, where applicable, have been complied with? if not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
- (vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, whether such accounts and records have been made and maintained;
- (vii) (a) Whether the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated.

(b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax or cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).

(viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, government or dues to debenture holders? If yes, the period and amount of default to be reported (in case of defaults to banks, financial institutions, and government, lender wise details to be provided);
- (ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purpose for which those are raised? If not, the details together with delays or defaults and subsequent rectification, if any, as may be applicable, be reported;
- (x) whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

- (xi) Whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with schedule V to the Companies Act? If not, the amount involved and steps taken by the company for securing refund of the same.
- (xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten percent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (xiii) whether all transactions with the related parties are in compliance with section 177 and 188 of the Companies Act, 2013 where applicable and the details have been disclosed in the financial statements etc., as required by the applicable accounting standards;(xiv) Whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;
- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

4. Reasons to be stated for unfavourable or qualified answers.-(1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be.

(2) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons why it is not possible for him to give his opinion on the same.

**List of Financial Institutions Covered Under
the Companies (Acceptance of Deposit) Rules, 2014**

1. Sub section (39) of section 2 of Companies Act, 2013 defines the term “financial institution” as, it includes a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934 (2 of 1934). The term financial institution has been defined under Section 45I clause (c) of the RBI Act 1934 as under:-

45I (c) “financial institution” means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:-

- (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;
- (ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;
- (iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972;
- (iv) the carrying on of any class of insurance business;
- (v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;
- (vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person, 2 [but does not include any institution, which carries on as its principal business,-
 - (a) agricultural operations; or
 - (aa) industrial activity; or]
 - (b) the purchase or sale of any goods (other than securities) or the providing of any services; or
 - (c) the purchase, construction or sale of immovable property, so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

Explanation.– For the purposes of this clause, “industrial activity” means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964;

Further “non-banking institution” has been defined under clause (e) of Section 45-I of RBI Act 1934 as under:-

45-I (e) “non-banking institution” means a company, corporation or cooperative society.

Further “non-banking financial company” has been defined under clause (f) of Section 45-I of RBI Act 1934 as under:-

45-I (f) “non-banking financial company” means–

- (i) a financial institution which is a company;
- (ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- (iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

2. Section 2(72) of the Companies Act, 2013 defines “public financial institutions “as follows:

- (i) the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956;
- (ii) the Infrastructure Development Finance Company Limited, referred to in clause (vi) of sub-section (1) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;
- (iii) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002;
- (iv) institutions notified by the Central Government under sub-section (2) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;
- (v) such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India:

Provided that no institution shall be so notified unless—

III.826 Auditing Pronouncements

- (A) it has been established or constituted by or under any Central or State Act; or
 - (B) not less than fifty-one per cent of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments;
3. Sub-section (72) of section 2 of the Act, empowers the Central Government to notify in the Official gazette such other institution as it may think fit to be a public financial institution. The Central Government has so far notified the following 58 public financial institutions:
1. The Industrial Reconstruction Bank of India established under the Industrial Reconstruction Bank of India Act, 1984.
 2. The General Insurance Corporation of India, formed and registered under the General Insurance Business (Nationalisation) Act, 1984.
 3. The National Insurance Company Limited, formed and registered under the Companies Act, 1956.
 4. The New India Assurance Company Limited, formed and registered under the Companies Act, 1956.
 5. The Oriental Fire and General Insurance Company Limited, formed and registered under the Companies Act, 1956.
 6. The United Fire and General Insurance Company Limited, formed and registered under the Companies Act, 1956.
 7. The Shipping Company and Investment Company of India Limited.
 8. Tourism Finance Corporation of India Limited, formed and registered under the Companies Act, 1956.
 9. IFCI Venture Capital Funds Limited formed and registered under the Companies Act, 1956.
 10. Technology Development and Informations Company of India Limited, formed and registered under the Companies Act, 1956.
 11. Power Finance Corporation Limited, formed and registered under the Companies Act, 1956.
 12. National Housing Bank, established under the NHB Act, 1987.

13. Small Industries Development Bank of India Limited established under the Small Industries Development Bank of India Act, 1989.
14. Rural Electrification Corporation Limited formed and registered under the Companies Act, 1956.
15. Indian Railway Finance Corporation Limited, formed and registered under the Companies Act, 1956.
16. Industrial Finance Corporation of India Limited, formed and registered under the Companies Act, 1956.
17. Andhra Pradesh State Financial Corporation.
18. Assam Financial Corporation.
19. Bihar State Financial Corporation.
20. Delhi Financial Corporation.
21. Gujarat Financial Corporation.
22. Haryana Financial Corporation.
23. Himachal Pradesh Financial Corporation.
24. Jammu and Kashmir State Financial Corporation.
25. Karnataka State Financial Corporation.
26. Kerala Financial Corporation.
27. Madhya Pradesh Financial Corporation.
28. Maharashtra State Financial Corporation.
29. Orissa State Financial Corporation.
30. Punjab Financial Corporation.
31. Rajasthan Financial Corporation.
32. Tamil Nadu Industrial Investment Corporation Limited.
33. Uttar Pradesh Financial Corporation.
34. West Bengal Financial Corporation.
35. Indian Renewable Energy Development Agency Limited.

III.828 Auditing Pronouncements

36. North Eastern Development Finance Corporation Limited.
37. Housing and Urban Development Corporation Limited.
38. Export and Import Bank of India.
39. National Bank for Agriculture and Rural Development (NABARD).
40. National Co-operative Department Corporation (NCDC).
41. National Dairy Development Bank (NDDB)
42. The Pradeshiya Industrial Development and Investment Corporation Limited.
43. Rajasthan State Industrial Development and Investment Corporation Limited.
44. The State Industrial and Investment Corporation of Maharashtra Limited.
45. West Bengal Industrial Development Corporation Limited.
46. Tamil Nadu Industrial Development Corporation Limited.
47. The Punjab State Industrial Development Corporation Limited (PSIDC).
48. Edc Limited
49. Tamil Nadu Power Finance And Infrastructure Development Corporation Limited
50. Tamilnadu Urban Finance And Infrastructure Development Corporation Limited
51. Kerala State Power And Infrastructure Finance Corporation Limited
52. Jammu And Kashmir Development Financial Corporation Limited
53. Kerala State Industrial Development Corporation Limited
54. India Infrastructure Finance Company Limited
55. Gujarat Industrial Investment Corporation Limited.
56. Andhra Pradesh Industrial Development Corporation Limited.
57. Karnataka Urban Infrastructure Development and Finance Corporation Limited
58. L&T Infrastructure Finance Company Limited.

Appendix IV

This checklist does not form part of the Guidance Note and is only illustrative in nature. Members are expected to exercise their professional judgment while making its use

depending upon facts and circumstances of each case and read this check list in conjunction with the Guidance Note on Companies (Auditor's Report) Order 2016.

**An Illustrative Checklist
on Companies (Auditor's Report) Order, 2016**

Client :

Audit Period :

Manager In-Charge:

Clause no.	Particulars	Remarks	Working Paper Reference
3(i)(a)	Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;		
(a)	Whether records of Fixed Assets (tangible, intangible and leased assets) are maintained showing the following particulars:		
	(i) Sufficient description (distinctive numbers, purchase agreement, documents, records and registration references, etc.) of the asset to make identification possible.		
	(ii) Classification, that is, the head under which it is shown in the accounts, e.g., plant and machinery, office equipment, etc. component-wise, as applicable		
	(iii) Location/situation.		
	(iv) Quantity, i.e., number of units.		
	(v) Original cost.		
	(vi) Year of purchase.		
	(vii) Adjustment for revaluation or for any increase or decrease in cost, e.g., on revaluation of foreign exchange liabilities.		
	(viii) Date of revaluation, if any.		
	(ix) Rate and basis of depreciation, useful life, particulars regarding amortisation and impairment		
	(x) Depreciation, amortisation and impairment for the current year.		

III.830 Auditing Pronouncements

- (xi) Accumulated depreciation, amortisation and impairment loss.
 - (xii) Particulars regarding sale, discarding, demolition, destruction etc.
 - (xiii) Particulars of fixed assets that have been retired from active use and held for disposal.
 - (xiv) Particulars of fixed assets that have been fully depreciated or amortised or impaired.
- (b) Whether aggregate original cost, depreciation or amortisation to date and impairment loss, if any, as per the register/records agrees with General Ledger balances? If not, note the disagreements in respect of each class of assets.

Conclusion:

3(i)(b) Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

- (a)
- (i) Whether Fixed Assets were physically verified at any time during the year or earlier years according to a phased program?
 - (ii) What is the periodicity of physical verification and whether the same is reasonable?
 - (iii) Whether assets physically verified agreed/ reconciled with book figures?
If not, note the discrepancies against each class of assets in terms of value, and state how the discrepancies have been dealt with.
 - (iv) Instructions to officials for carrying out physical verification to include procedures, timing, competency of team members, count sheets/tags, formats etc.
- (b) Physically verify few items from the fixed asset register & vice versa.

(c) Whether management representation is obtained confirming that:

- ◆ fixed assets are physically verified by the company in accordance with the policy of the company.

- ◆ periodicity of the physical verification of fixed assets.

- ◆ details of the material discrepancies noticed during the physical verification of the fixed assets.

- ◆ If no discrepancies were noted during physical verification, the same should be clearly mentioned.

Conclusion:

3(i)(c) Whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;

(a) Does the company have any immovable properties (land and buildings)?

Has the Company identified the land and building on the basis of Fixed Asset Register.

(b) Whether the title deeds of these immovable properties are in the name of the company?

Whether the details as per title deeds reconcile with the details in Fixed assets register, if not, is there any material difference to be reported here

(c) Has the management provided details of immovable properties not held in company's name (for example, location, description, and reasons for not being held in the company's name?

(i) In case the title deeds are lost, assess whether the certified copies of such documents are available with the company and what actions have been taken by the management in this regard?

III.832 Auditing Pronouncements

(ii) In case the title deeds are mortgaged with the lenders, assess if the confirmation from the lenders is obtained for the same.

(iii) The discrepancies observed should be reported in the CARO report.

3(ii) Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;

(a) Has the management physically verified the inventory, as defined in AS 2? Inventory normally includes-

- ◆ Raw materials and Components
- ◆ Packing materials
- ◆ Maintenance supplies
- ◆ Work in progress
- ◆ Finished Goods
- ◆ Stores and Spares
- ◆ Consumables and Loose tools

(b) Whether evidence of physical verification has been seen and reasonableness of periodicity of physical verification evaluated? If yes, verify:

- ◆ written instructions issued by the management.
- ◆ duly authenticated physical verification sheets.
- ◆ duly authenticated summary sheets/ consolidation sheet
- ◆ internal memo etc. regarding issues arising on physical verification.
- ◆ any other documents evidencing physical verification.

(c) Whether the original physical verification sheets have been reviewed and selected items traced into the final inventories? (including the more valuable ones as per ABC

- classification)
- (d) Whether the comparison of final inventories with stock has been done? Whether records and other corroborative evidence, e.g. inventory statements submitted to banks?
 - (e) In case of continuous stock taking method, whether management:
 - (i) maintains adequate and up-to-date stock records;
 - (ii) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and
 - (iii) check/examine thoroughly and corrects all material differences between the book records and the physical counts.
 - (f) Whether stock register is updated and value of inventory extracted from it tally with the books of account.
 - (g) If any material discrepancies were found as compared to stock records, what were the extent of discrepancies (in terms of value) and how the same have been dealt with in the books of account as well as in the stock records?

Conclusion:

- 3(iii)(a) Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so, whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;**

- (i) Has the Company granted any loans (Secured or Unsecured) to companies, firms, limited liability partnerships or other parties covered in the register maintained under

III.834 Auditing Pronouncements

Section 189 of the Companies Act 2013?

(ii) Where the company has granted any loans to parties covered in the register maintained under section 189 of the Act and squared off during the year, obtain details of such transactions.

(iii) Whether the terms of the above loans are prima facie prejudicial, due consideration to be given to the factors mentioned below:

- ◆ terms & condition of the loan repayment, rate of interest, restrictive covenants etc.,
- ◆ company's financial standing, its ability to lend, and terms of its borrowings
- ◆ borrower's financial standing
- ◆ the nature of the security,
- ◆ prevailing rate of interest, etc.

Conclusion:

3(iii)(b) Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

- (a) Whether the schedule of repayment of principal and payment of interest has been stipulated in the loan agreements / mutually agreed letter of arrangement at the time of sanction?
- (b) Whether repayment of principal amount and interest thereon are received regularly on the due date or immediately thereafter?
- (c) If not, the fact and details should be Obtained.

Conclusion:

3(iii)(c) If the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

- (a) Whether list of overdue amount has been prepared & recorded and reasonable steps taken for recovery of amount of loan which is overdue more than ninety days?

- (b) Following documents may be seen for verification of reasonableness of steps taken by the company for recovery of principal and accrued interest on loan granted:

- ◆ Facts of each case including amounts involved
- ◆ Issue of reminder
- ◆ Sending of advocates or solicitor's notice

In absence of legal steps whether auditor is satisfied that reasonable steps have been taken

- (c) Obtain management's representation regarding steps that have been taken for recovery of total amount overdue more than ninety days.

Conclusion:

- 3(iv) In respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.**

- (a) Where Companies has given loans to directors etc.:

(i) Whether any loans given to directors or any other person in whom the director is interested, or given any guarantee or provided any security in connection with any loan taken by directors or such other person?

(ii) Whether any of the transaction is attracting the provisions of section 185?

(iii) Whether any of such transactions are covered under the exceptions provided under section 185? If so, obtain the relevant evidences ensuring such exemption.

- (b) Where company has made loan/ investment

(i) Obtain the details of loans and investment made by the Company including opening balances

III.836 Auditing Pronouncements

(ii) Whether company has made investment through more than two layers of investment companies?

(iii) Whether the company has exceeded the limit of sixty per cent of its paid-up share capital, free reserves and securities premium account or one hundred per cent of its free reserves and securities premium account, whichever is more?

(iv) If so, whether prior approval by means of a special resolution passed at a general meeting has been obtained?

(v) Whether the rate of interest charges is more or at par to the rates specified in subsection (7) of section 186 of the Act, if not, the reasons thereof,

Conclusion:

3(v) In case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed thereunder, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other tribunal, whether the same has been complied with or not?

(a) If the Company has accepted deposits from the public state whether:

(i) The directives issued by the Reserve Bank of India have been complied with and also that:

(ii) The provisions of Section 73 to 76 of the Companies Act, 2013 and the rules framed there under have been complied with.

(iii) List out contraventions, if any.

(b) Where an order has been passed by the CLB or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal in respect of above, examine the steps taken by the company to comply with

the order, and if not, report briefly stating there in the nature of contravention and the fact that Company has not complied with the order.

Conclusion:

3(vi) Whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

- (a) Whether cost accounting records have been prescribed for the company under section 148(1) of the Companies Act, 2013? If so verify whether proper cost accounts and records are made and maintained by the Company as specified.

Conclusion:

3(vii)(a) Whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

- (a) Whether a list of statutory dues which company is required to deposit regularly has been obtained.
- (b) In case where there are no arrears on the balance sheet date but the company has been irregular during the year in depositing the statutory dues, the fact should be stated.
- (c) Whether the Company has been generally regular in depositing statutory dues or otherwise, indicate the same.

Note: A matter is disputed where there is a positive evidence or action on the part of the company to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal.

III.838 Auditing Pronouncements

- (d) Whether penalty and/or interest levied under the respective law is included under amounts payable.
- (e) Ensure that disclosure is restricted to the actual arrears and should not include the amounts which have not fallen due for deposit and have been shown as arrears at the balance sheet date.
- (f) Whether the information about arrears of outstanding statutory dues is provided in the format:
- ◆ Name of the Statute
 - ◆ Nature of the dues
 - ◆ Amount (Rs.)
 - ◆ Period to which amount relates
 - ◆ Due date
 - ◆ Date of Payment
- (g) Whether a written representation with reference to the date of the balance sheet from the management obtained:
- ◆ specifying the cases and the amounts considered disputed;
 - ◆ containing a list of the cases and the amounts in respect of the statutory dues which are undisputed and have remained outstanding for a period of more than six months from the date they became payable;
 - ◆ containing a statement as to the completeness of the information provided by the management.
- (h) Whether any register of significant laws with which the entity has to comply within its particular industry and a record of complaints in respect of non-compliance been maintained
- Conclusion:
- 3(vii)(b) Where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of**

any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned department shall not be treated as a dispute.)

- (a) Review internal audit report, minutes of the meeting of the board of Directors and audit committee
- (b) Ensure that information about arrears of disputed statutory dues is provided in the format:
 - ◆ Name of the Statute
 - ◆ Nature of the dues
 - ◆ Amount (Rs.)
 - ◆ Period to which amount relates
 - ◆ Forum where dispute is pending

Conclusion:

- 3(viii) Whether the company has defaulted in repayment of loans or borrowings to a financial institution, bank, government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and government, lender wise details to be provided).**
- (a) Whether all defaults existing at the balance sheet date are reported irrespective of when those defaults have occurred.
 - (b) In case of defaults to banks, financial institutions, and government, whether lender wise details reported?
 - (c) If application of reschedulement of loan has been made/accepted or default has been made good during the accounting period, whether the fact has been stated.
 - (d) Whether the disputes between the company and the lender on various issues give rise to disclaimer stating the fact there is a dispute between the company and the lender and auditor is unable to determine whether there is a default in repayment of dues to the lender concerned.

Conclusion:

- 3(ix) Whether moneys raised by way of initial public offer or further public offer (including debt instruments) and the term loans were applied for the purposes for which those were raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;**
- (a) Whether the company raised money by way of initial public offer or further public offer of equity shares, convertible securities and debt securities?
 - (b) Examine the terms and conditions stated in the offer document subject to which the company has raised the above mentioned money.
 - (c) Whether the end use of the money raised (as mentioned above) is capable of being determined? If not state the fact.
 - (d) Whether the said end-use of money disclosed in the financial statements by way of a Note is significantly different from the actual end use? If so, state the fact.
 - (e) Examine the various documents submitted to SEBI, offer document and also examine the report of board of directors, if available, to find out whether funds raised have been utilized for the purpose for which they were raised.
 - (f) Whether a representation of the management has been obtained as to the completeness of the disclosures with regard to the end-use of moneys raised by initial public offer and further public offer?
 - (g) Whether the fund flow statement has been reviewed where one to one correlation is not possible.
 - (h) Whether the company has taken any term loan?
 - (i) Examine the terms and conditions subject to which the company has obtained the term

loans including purpose for which term loans were sanctioned?

- (j) Compare the purpose for which term loans were sanctioned with the actual utilisation of the loans and obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised.
 - (k) In case during a construction phase surplus funds were temporarily invested, however, subsequently the same are utilised for the stated objectives, mention the fact that the funds were temporarily used for the purpose other than for which the loan was sanctioned but were ultimately utilised for the stated end-use.
 - (l) Whether term loans taken were not applied for stated purpose during the year for any reason? If yes, mention the facts and amount. Also disclose the fact about utilization of term loan of earlier year in current year.
 - (m) Whether the fund flow statement has been reviewed where one to one correlation was not possible.
Conclusion:
- 3(x) Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated;**
- (a) Has SA 240 been complied with? (Attach the check list for compliance of SA 240 with this check list also).
 - (b) Examine the following to ascertain whether any fraud has been reported or noticed by the management?
 - ◆ the reports of the internal Audit
 - ◆ the auditor should enquire from the management about any frauds by the company or any fraud on the company by

III.842 Auditing Pronouncements

its officers or employees, that it has noticed or that have been reported to it.

- ◆ discuss the matter with other employees including officers of the company.
- ◆ examine the minutes book of the board meeting, audit committee etc., of the company in this regard.

- (c) Where any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported, determine the nature and amount of frauds and disclose the same. Obtain management representation to this effect.
- (d) Whether any fraud has been reported by the auditor during the year under section 143(12)? If so, determine whether that same would be reported under this clause?

Conclusion:

3 (xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;

- (a) Has the company paid or provided for any managerial remuneration?
- (b) Obtain from management the details of managerial remuneration paid/ provided by the Company

Ensure that the computation of managerial remuneration is done in accordance with the provisions of section 197 read with Schedule V of Companies Act, 2013. The remuneration does not include :

- ◆ Sitting Fees (within prescribed limits) (sub section 2 and 5 of Section 197)
 - ◆ Remuneration for professional services rendered (Sub section 4 of Section 197)
- (c) Obtain a general understanding of Section 197 read with Schedule V to the Act. Ascertain the

system and procedures of the company to ensure compliance with the provisions of section 197 and Schedule V

- (d) Based on the understanding so gained, perform a reasonable test check of compliance with the aforesaid requirements of the Act.
- (e) Examine the steps taken by the company to comply with requirements of the Act with respect to managerial remuneration. Examine the correspondence and documents filed with the Registrar of Companies, Company Law Board, legal correspondence for orders passed, minutes of the meetings of the Board and shareholders.
- (f) Examine whether the Company has obtained requisite approvals mandated by section 197 read with Schedule V to the Act.
- (g) Obtain a listing of managerial remuneration rejected/ partially approved. Examine the same with underlying documents and obtain understanding of the steps taken by the Company for refund of unapproved managerial remuneration for reporting along with the amount involved.
Assess if the management has waived recovery of the excess amount paid over and above the prescribed limit.
- (h) Consider the implications of non-compliances above also in the auditors' opinion on the financial statements.

In case of non-compliance, the amount involved would be the total amount involved which is in excess of the limit prescribed even though during the year the company may have recovered or partially recovered such amount. Obtain, examine and record the steps taken to secure the refund also

3(xii) Whether the Nidhi Company has complied with the Net Owned Funds to

Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

- (a) Is the Company a nidhi company?

Assess if the Company is registered as a Nidhi Company as per provisions of Section 406 of the Companies Act 2013 or Section 620A of the Companies Act, 1956.

- (b) To check compliance with the following:

a) Whether the net owned funds to deposits ratio is more than 1:20 to meet out the liability as on the date of balance sheet?

b) Examine whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability

Whether the calculation of net owned funds is done as per Rule 3(d) which includes equity share capital, and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet:

Assess if the proceeds of issue of preference shares have been included in the net owned funds.

Ensure that ratio is computed by using the figures of net owned funds and deposit liability computed in accordance with as stated under this clause.

Conclusion:

- 3 (xiii) Whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;**

- (a) Obtain a statement containing details of transactions with related parties

Obtain a list of companies, firms or other parties, the particulars of which are required to be entered in the register maintained under

section 189 of the Act.

Obtain declarations made by the directors in Form MBP-1 i.e., general notice received from a director under Rule 9(1) of The Companies (Meetings of Board and Power) Rules, 2014

Verify the entries made in the register under section 189 with such statement from management and declarations received from directors.

Assess the additions/ deletions to such list for appropriateness based on relevant declarations

- (b) Obtain understanding of requirements of section 177 and 188 of the Act in relation to related party transactions
- (c) Perform reasonable check to ascertain completeness and accuracy of details in the statement.
- (d) Ascertain the system and procedures of the company to ensure compliance with the provisions of section 177 and 188 of the Act Including the assessment of identification of related parties and whether the transaction is at arm's length and basis of such conclusion.
- (e) Based on the understanding so gained, perform a reasonable test check of compliance with the aforesaid requirements of the Act.
- (f) Examine minutes of meetings of the audit committee and agreements underlying related party transactions to ascertain audit committee approval for the transactions.
- (g) Examine the minutes of Board meetings to ascertain whether requisite approvals of Board is obtained for certain related party transactions as required under section 188 of the Act.

III.846 Auditing Pronouncements

- (h) Where shareholders' approval is required, check whether the requisite approvals have been obtained as required under Section 188 of the Act
 - (i) Examine whether related party disclosures are made in the financial statements as per the requirements of Accounting Standard 18
 - (j) Examine whether disclosure related to contracts or arrangements with related parties as mandated by section 188 are made in Board's report
Including the assessment of identification of related parties and whether the transaction is at arm's length and basis of such conclusion.
 - (k) Consider the implications of non-compliances above also in the auditors' opinion on the financial statements.
- 3 (xiv) Whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;**
- (a) Has the Company made any preferential allotment or private placement of shares or fully convertible debentures during the year.
 - (b) Obtain a statement containing the specific terms of offer for private placement, including purpose for which funds were raised, and the details of subsequent application-amounts, dates and the purpose.
 - (c) Ascertain whether the offer and allotment of securities referred in 1 above are in compliance with the requirements mandated by section 42 of the Act.
 - (d) Based on the understanding so gained, perform a reasonable test check of

compliance with the requirements of the Act.

- (e) Consider the implications of non-compliances above also in the auditors' report on the financial statements.

Note: Reporting under this Clause is required also in instances where the amounts have been raised in earlier year(s) and is being utilized under the year under review.

3 (xv) Whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;

- (a) Obtain a statement containing list of directors of the company, its holding company, subsidiary and associate companies and persons connected with the directors

- (b) Scrutinise the following books of account, records and documents could provide source of such audit evidence to the auditor as to the existence of such non-cash transactions as well as persons connected with the Directors:

(i) Form No. MBP 1, Notice of Interest by Director, filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014

(ii) Form No. MBP 2, Register of Loans, Guarantee, Security and Acquisition Made by the Company, filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014

(iii) Form No. MBP 4, Register of Contracts with Related Party and Contracts and Bodies etc. in which Directors are Interested, filed pursuant to the Companies (Meetings of Board and Its Powers) Rules, 2014

(iv) Movements in the Fixed Asset Register

(v) Minutes book of the General Meeting

III.848 Auditing Pronouncements

and Meetings of Directors

(vi) Report on Annual General Meeting pursuant to Companies (Management and Administration) Rules, 2014

Minutes of meetings of Board of Directors and Audit committee

- (c) Obtain a statement from management containing transactions between the Company and director(s) referred to above
- (d) Perform reasonable check to ascertain non cash transactions
- (e) Obtain understanding of requirements of section 192 of the Act.
- (f) Based on the understanding so gained, perform a reasonable test check of compliance with the aforesaid requirements of the Act.
- (g) Consider the implications of non-compliances above also in the auditors' opinion on the financial statements.

3 (xvi) Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

- (a) Examine the financial statements of the Company and assess whether the company has financial assets and financial income
Note: According to the RBI press release 1998-99/1269 dated 08.04.1999, a company will be treated as NBFC if its financial assets are more than 50% of its total assets (netted off by intangible assets) and income from financial assets should be more than 50% of its gross income.
- (b) Check whether the company has financing activity as a principal business of the Company.
- (c) Obtain understanding of the requirements of section 45-IA of RBI Act, 1934 with regard to

- registration of the company with RBI
- (d) Examine whether the Company is carrying out NBFC activity / Core investment company.
 - (e) Examine the steps taken by the company to comply with requirements of the RBI Act, 1934 with respect to registration as a NBFC. Also examine the correspondence and documents filed with the RBI, minutes of the Board meeting.
 - (f) Examine whether the Company has obtained Certificate of Registration from RBI in terms of section 45-IA of the RBI Act, 1934.
 - (g) Consider the implications of non-compliances above also in the auditors' opinion on the financial statements.

Discussed with.....
Designation.....
Date.....

Appendix V

Text of Sections 185 and 186 of the Companies Act, 2013 and Relevant Extract of the Rules

Text of Section 185 of the Companies Act, 2013¹⁵

- (1) Save as otherwise provided in this Act, no company shall, directly or indirectly, advance any loan, including any loan represented by a book debt, to any of its directors or to any other person in whom the director is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person:

Provided that nothing contained in this sub-section shall apply to—

¹⁵ MCA *vide* its Notification No. GSR 464(E) dated 5-6-2015 provides that in case of private companies section 185 shall not apply to a private company –

- (a) in whose share capital no other body corporate has invested any money;
- (b) if the borrowings of such a company from banks or financial institutions or any body corporate is less than twice of its paid up share capital or fifty crore rupees, whichever is lower; and
- (c) such a company has no default in repayment of such borrowings subsisting at the time of making transactions under this section.

III.850 Auditing Pronouncements

- (a) the giving of any loan to a managing or whole-time director—
 - (i) as a part of the conditions of service extended by the company to all its employees; or
 - (ii) pursuant to any scheme approved by the members by a special resolution; or
- (b) a company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan and in respect of such loans and interest is charged at a rate not less than the bank rate declared by the Reserve Bank of India; or
- (c) any loan made by a holding company to its wholly owned subsidiary company or any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company; or
- (d) any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company:
Provided that the loans made under clauses (c) and (d) are utilised by the subsidiary company for its principal business activities.

Explanation.—For the purposes of this section, the expression “to any other person in whom director is interested” means—

- (a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;
 - (b) any firm in which any such director or relative is a partner;
 - (c) any private company of which any such director is a director or member;
 - (d) any body corporate at a general meeting of which not less than twenty five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or
 - (e) any body corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.
- (2) If any loan is advanced or a guarantee or security is given or provided in contravention of the provisions of sub-section (1), the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, and the director or the other person to whom any loan is advanced or guarantee or security is given or provided in connection with any loan taken by him or the other person, shall be punishable with imprisonment which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.

Text of Section 186 of the Companies Act, 2013 and Relevant Extract of the Rules

- (1) Without prejudice to the provisions contained in this Act, a company shall unless otherwise prescribed, make investment through not more than two layers of investment companies:

Provided that the provisions of this sub-section shall not affect,—

- (i) a company from acquiring any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;
 - (ii) a subsidiary company from having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.
- (2) No company shall directly or indirectly —
- (a) give any loan to any person or other body corporate;
 - (b) give any guarantee or provide security in connection with a loan to any other body corporate or person; and
- (c) acquire by way of subscription, purchase or otherwise, the securities of any other body corporate, exceeding sixty per cent. of its paid-up share capital, free reserves and securities premium account or one hundred per cent. of its free reserves and securities premium account, whichever is more.
- (3) Where the giving of any loan or guarantee or providing any security or the acquisition under sub-section (2) exceeds the limits specified in that sub-section, prior approval by means of a special resolution passed at a general meeting shall be necessary.
- (4) The company shall disclose to the members in the financial statement the full particulars of the loans given, investment made or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to be utilised by the recipient of the loan or guarantee or security.
- (5) No investment shall be made or loan or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting and the prior approval of the public financial institution concerned where any term loan is subsisting, is obtained:

Provided that prior approval of a public financial institution shall not be required where the aggregate of the loans and investments so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate, along

III.852 Auditing Pronouncements

with the investments, loans, guarantee or security proposed to be made or given does not exceed the limit as specified in sub-section (2), and there is no default in repayment of loan instalments or payment of interest thereon as per the terms and conditions of such loan to the public financial institution.

- (6) No company, which is registered under section 12 of the Securities and Exchange Board of India Act, 1992 and covered under such class or classes of companies as may be prescribed, shall take inter-corporate loan or deposits exceeding the prescribed limit and such company shall furnish in its financial statement the details of the loan or deposits.
- (7) No loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan.
- (8) No company which is in default in the repayment of any deposits accepted before or after the commencement of this Act or in payment of interest thereon, shall give any loan or give any guarantee or provide any security or make an acquisition till such default is subsisting.
- (9) Every company giving loan or giving a guarantee or providing security or making an acquisition under this section shall keep a register which shall contain such particulars and shall be maintained in such manner as may be prescribed.
- (10) The register referred to in sub-section (9) shall be kept at the registered office of the company and —
 - (a) shall be open to inspection at such office; and
 - (b) extracts may be taken therefrom by any member, and copies thereof may be furnished to any member of the company on payment of such fees as may be prescribed.
- (11) Nothing contained in this section, except sub-section (1), shall apply—
 - (a) to a loan made, guarantee given or security provided by a banking company or an insurance company or a housing finance company in the ordinary course of its business or a company engaged in the business of financing of companies or of providing infrastructural facilities;
 - (b) to any acquisition—
 - (i) made by a non-banking financial company registered under Chapter IIIB of the Reserve Bank of India Act, 1934 and whose principal business is acquisition of securities:
Provided that exemption to non-banking financial company shall be in respect of its investment and lending activities;
 - (ii) made by a company whose principal business is the acquisition of

securities; of shares allotted in pursuance of clause (a) of sub-section (1) of section 62.

- (iii) made by a banking company or an insurance company or a housing finance company, making acquisition of securities in the ordinary course of its business.

- (12) The Central Government may make rules for the purposes of this section.
- (13) If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

Explanation.—For the purposes of this section,—

- (a) the expression “investment company” means a company whose principal business is the acquisition of shares, debentures or other securities;
- (b) the expression “infrastructure facilities” means the facilities specified in Schedule VI.

Rules 11, 12 and 13 of the Companies (Meeting of Board and its Powers) Rules, 2014

Rule.11. Loan and investment by a company under section 186 of the Act.-

- (1) Where a loan or guarantee is given or where a security has been provided by a company to its wholly owned subsidiary company or a joint venture company, or acquisition is made by a holding company, by way of subscription, purchase or otherwise of, the securities of its wholly owned subsidiary company, the requirement of sub-section (3) of section 186 shall not apply.

Provided that the company shall disclose the details of such loans or guarantee or security or acquisition in the financial statement as provided under sub-section (4) of section 186.

- (2) For the purposes of clause (a) of sub-section (11) of section 186, the expression “business of financing of companies” shall include, with regard to a Non-Banking Financial Company registered with the Reserve Bank of India, “business of giving of any loan to a person or providing any guaranty or security for due repayment of any loan availed by any person in the ordinary course of its business”.
- (3) No company registered under section 12 of the Securities and Exchange Board of India Act, 1992 and also covered under such class or classes of companies which may be notified by the Central Government in consultation with the Securities and

III.854 Auditing Pronouncements

Exchange Board, shall take any inter-corporate loan or deposits, in excess of the limits specified under the regulations applicable to such company, pursuant to which it has obtained certificate of registration from the Securities and Exchange Board of India.

Rule.12. Register.-

- (1) Every company giving loan or giving guarantee or providing security or making an acquisition of securities shall, from the date of its incorporation, maintain a register in Form MBP 2 and enter therein separately, the particulars of loans and guarantees given, securities provided and acquisitions made as aforesaid
- (2) The entries in the register shall be made chronologically in respect of each such transaction within seven days of making such loan or giving guarantee or providing security or making acquisition.
- (3) The register shall be kept at the registered office of the company and the register shall be preserved permanently and shall be kept in the custody of the company secretary of the company or any other person authorised by the Board for the purpose.
- (4) The entries in the register (either manual or electronic) shall be authenticated by the company secretary of the company or by any other person authorised by the Board for the purpose.
- (5) For the purpose of sub-rule (4), the register can be maintained either manually or in electronic mode.
- (6) The extracts from the register maintained under sub-section (9) of section 186 may be furnished to any member of the company on payment of such fee as may be prescribed in the Articles of the company which shall not exceed ten rupees for each page.

Rule 13.Special Resolution.-

- (1) Where the aggregate of the loans and investment so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate along with the investment, loan, guarantee or security proposed to be made or given by the Board, exceed the limits specified under section 186, no investment or loan shall be made or guarantee shall be given or security shall be provided unless previously authorised by a special resolution passed in a general meeting.

Explanation.-For the purpose of this sub-rule, it is clarified that it would sufficient compliance if such special resolution is passed within one year from the date of notification of this section.

- (2) A resolution passed at a general meeting in terms of sub-section (3) of section 186 to give any loan or guarantee or investment or providing any security or the

acquisition under sub section (2) of section 186 shall specify the total amount up to which the Board of Directors are authorised to give such loan or guarantee, to provide such security or make such acquisition:

Provided, that the company shall disclose to the members in the financial statement the full particulars in accordance with the provision of sub-section (4) of section 186.

Clarification with regard to section 185 and 186 of the Companies Act 2013 - loans and advances to employees-

Ministry of Corporate Affairs vide General Circular No, 04/2015 dated 10th March, 2015 has clarified that loans and/or advances made by the companies to their employees, other than the managing or whole time directors (which is governed by section 185) are not governed by the requirements of section 186 of the Companies Act, 2013. This clarification will, however, be applicable if such loans/advances to employees are in accordance with the conditions of service applicable to employees and are also in accordance with the remuneration policy, in cases where such policy is required to be formulated.

Appendix VI

Text of the Companies (Cost Records and Audit) Rules, 2014

1. **Short title and commencement.-** (1) These rules may be called the Companies (Cost Records and Audit) Rules, 2014.
 - (2) They shall come into force on the date of publication in the Official Gazette.
2. **Definitions:** In these rules, unless the context otherwise requires –
 - (a) “Act” means the Companies Act, 2013 (18 of 2013);
 - (aa) “Central Excise Tariff Act Heading” means the heading as referred to in the additional notes in the first schedule to the Central Excise Tariff Act, 1985;
 - (b) “Cost Accountant in practice” means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959), who holds a valid certificate of practice under sub-section (1) of section 6 of that Act and who is deemed to be in practice under sub-section (2) of section 2 thereof, and includes a firm or limited liability partnership of cost accountants;
 - (c) “cost auditor” means a Cost Accountant in practice, as defined in clause (b), who is appointed by the Board;
 - (d) “cost audit report” means the report duly audited and signed by the cost auditor including attachment, annexure, qualifications or observations etc. to cost audit report;

III.856 Auditing Pronouncements

- (e) “cost records” means books of account relating to utilisation of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in section 148 of the Act and these rules;
- (f) “form” means a form annexed to these rules;
- (g) “institute” means the Institute of Cost Accountants of India constituted under the Cost and Works Accountants Act, 1959 (23 of 1959);
- (h) all other words and expressions used in these rules but not defined, and defined in the Act or in the Companies (Specification of Definition Details) Rules, 2014 shall have the same meanings as assigned to them in the Act or in the said rules.

3. Application of cost records.—For the purposes of sub-section (1) of section 148 of the Act, the class of companies, including Foreign Companies defined clause (42) of section 2 of the Act, engaged in the production of the goods or providing services, specified in the table below, having an overall turnover from all its products and services of rupees thirty five crore or more during the immediately preceding financial year, shall include cost records for such products or services in their books of account, namely:-

Note - Readers may refer the table as given in the Rules for further details.

4. Applicability for cost audit.-

- (1) Every company specified in item (A) of the rule of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees fifty crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees twenty five crore or more.
- (2) Every company specified in item (B) of rule 3, shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees one hundred crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees thirty five crore or more.
- (3) The requirement for cost audit under these rules shall not apply to a company which is covered in rule 3 and –
 - (i) whose revenue from exports, in foreign exchange, exceeds, seventy five percent of its total revenue; or
 - (ii) which is operating from a special economic zone.

5. Maintenance of records.-

- (1) Every company under these rules including all units and branches thereof, shall, in respect of each of its financial year commencing on or after the 1st day of April, 2014, maintain cost records in form CRA-1.

Provided that in case of company covered in serial numbers 12 and serial numbers 24 to 32 of item (B) of rule 3, the requirement under this rule shall apply in respect of each of its financial year commencing on or after 1st day of April, 2015.

- (2) The cost records referred to in sub-rule (1) shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.
- (3) The cost records shall be maintained in such manner so as to enable the company to exercise, as far as possible, control over the various operations and costs to achieve optimum economies in utilization of resources and these records shall also provide necessary data which is required to be furnished under these rules.

6. Cost audit.-

- (1) The category of companies specified in rule 3 and the thresholds limits laid down in rule 4, shall within one hundred and eighty days of the commencement of every financial year, appoint a cost auditor.
- (2) Every company referred to in sub-rule (1) shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.
- (3) Every cost auditor appointed as such shall continue in such capacity till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.
- (3A) Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the Board of Director within thirty days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within thirty days of such appointment of cost auditor;
- (4) Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in form CRA-3.

III.858 Auditing Pronouncements

- (5) Every cost auditor shall forward his report to the Board of Directors of the company within a period of one hundred and eighty days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.
- (6) Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in form CRA-4 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.
- (7) The provisions of sub-section (12) of section 143 of the Act and the relevant rules made thereunder shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Appendix VII

Text of Section 197 of Companies Act, 2013 and Relevant Extract of the Rules and Schedule V

197. (1) The total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year shall not exceed eleven per cent of the net profits of that company for that financial year computed in the manner laid down in section 198 except that the remuneration of the directors shall not be deducted from the gross profits:

Provided that the company in general meeting may, with the approval of the Central Government, authorise the payment of remuneration exceeding eleven per cent of the net profits of the company, subject to the provisions of Schedule V:

Provided further that, except with the approval of the company in general meeting,—

- (i) the remuneration payable to any one managing director; or whole-time director or manager shall not exceed five per cent of the net profits of the company and if there is more than one such director remuneration shall not exceed ten per cent of the net profits to all such directors and manager taken together;
- (ii) the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed,—

- (A) one per cent of the net profits of the company, if there is a managing or whole-time director or manager;
- (B) three per cent of the net profits in any other case.

(2) The percentages aforesaid shall be exclusive of any fees payable to directors under sub-section (5).

(3) Notwithstanding anything contained in sub-sections (1) and (2), but subject to the provisions of Schedule V, if, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole time director or manager, by way of remuneration any sum exclusive of any fees payable to directors under sub-section (5) hereunder except in accordance with the provisions of Schedule V and if it is not able to comply with such provisions, with the previous approval of the Central Government.

(4) The remuneration payable to the directors of a company, including any managing or whole-time director or manager, shall be determined, in accordance with and subject to the provisions of this section, either by the articles of the company, or by a resolution or, if the articles so require, by a special resolution, passed by the company in general meeting and the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him for the services rendered by him in any other capacity:

Provided that any remuneration for services rendered by any such director in other capacity shall not be so included if—

- (a) the services rendered are of a professional nature; and
- (b) in the opinion of the Nomination and Remuneration Committee, if the company is covered under sub-section (1) of section 178, or the Board of Directors in other cases, the director possesses the requisite qualification for the practice of the profession.

(5) A director may receive remuneration by way of fee for attending meetings of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board:

Provided that the amount of such fees shall not exceed the amount as may be prescribed:

Provided further that different fees for different classes of companies and fees in respect of independent director may be such as may be prescribed.

III.860 Auditing Pronouncements

(6) A director or manager may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other.

(7) Notwithstanding anything contained in any other provision of this Act but subject to the provisions of this section, an independent director shall not be entitled to any stock option and may receive remuneration by way of fees provided under sub-section (5), reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.

(8) The net profits for the purposes of this section shall be computed in the manner referred to in section 198.

(9) If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed by this section or without the prior sanction of the Central Government, where it is required, he shall refund such sums to the company and until such sum is refunded, hold it in trust for the company.

(10) The company shall not waive the recovery of any sum refundable to it under sub-section (9) unless permitted by the Central Government.

(11) In cases where Schedule V is applicable on grounds of no profits or inadequate profits, any provision relating to the remuneration of any director which purports to increase or has the effect of increasing the amount thereof, whether the provision be contained in the company's memorandum or articles, or in an agreement entered into by it, or in any resolution passed by the company in general meeting or its Board, shall not have any effect unless such increase is in accordance with the conditions specified in that Schedule and if such conditions are not being complied, the approval of the Central Government had been obtained.

(12) Every listed company shall disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration and such other details as may be prescribed.

(13) Where any insurance is taken by a company on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer or Company Secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel:

Provided that if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration.

(14) Subject to the provisions of this section, any director who is in receipt of any commission from the company and who is a managing or whole-time director of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board's report.

(15) If any person contravenes the provisions of this section, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Rule 4 and 5 of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014.

Rule 4. Sitting fees.- A company may pay a sitting fee to a director for attending meetings of the Board or committees thereof, such sum as may be decided by the Board of directors thereof which shall not exceed one lakh rupees per meeting of the Board or committee thereof:

Provided that for Independent Directors and Women Directors, the sitting fee shall not be less than the sitting fee payable to other directors.

Rule 5. Disclosure in Board's report.-(1) Every listed company shall disclose in the Board's report-

- (i) the ratio of the remuneration of each director to the median remuneration of the employees of the company for the financial year;
- (ii) the percentage increase in remuneration of each director, Chief Financial Officer, Chief Executive Officer, Company Secretary or Manager, if any, in the financial year;
- (iii) the percentage increase in the median remuneration of employees in the financial year;
- (iv) the number of permanent employees on the rolls of company;
- (v) the explanation on the relationship between average increase in remuneration and company performance;
- (vi) comparison of the remuneration of the Key Managerial Personnel against the performance of the company;
- (vii) variations in the market capitalisation of the company, price earnings ratio as at the closing date of the current financial year and previous financial year and percentage increase over decrease in the market quotations of the shares of the company in comparison to the rate at which the company came out with the last public offer in

III.862 Auditing Pronouncements

case of listed companies, and in case of unlisted companies, the variations in the net worth of the company as at the close of the current financial year and previous financial year;

- (viii) average percentile increase already made in the salaries of employees other than the managerial personnel in the last financial year and its comparison with the percentile increase in the managerial remuneration and justification thereof and point out if there are any exceptional circumstances for increase in the managerial remuneration;
- (ix) comparison of the each remuneration of the Key Managerial Personnel against the performance of the company;
- (x) the key parameters for any variable component of remuneration availed by the directors;
- (xi) the ratio of the remuneration of the highest paid director to that of the employees who are not directors but receive remuneration in excess of the highest paid director during the year; and
- (xii) affirmation that the remuneration is as per the remuneration policy of the company.

Explanation.- For the purposes of this rule.- (i) the expression “median” means the numerical value separating the higher half of a population from the lower half and the median of a finite list of numbers may be found by arranging all the observations from lowest value to highest value and picking the middle one;

- (ii) if there is an even number of observations, the median shall be the average of the two middle values.
- (2) The Board’s report shall include a statement showing the name of every employee of the company, who-
- (i) if employed throughout the financial year, was in receipt of remuneration for that year which, in the aggregate, was not less than sixty lakh rupees;
 - (ii) if employed for a part of the financial year, was in receipt of remuneration for any part of that year, at a rate which, in the aggregate, was not less than five lakh rupees per month;
 - (iii) if employed throughout the financial year or part thereof, was in receipt of remuneration in that year which, in the aggregate, or as the case may be, at a rate which, in the aggregate, is in excess of that drawn by the managing director or whole-time director or manager and holds by himself or along with his spouse and dependent children, not less than two percent of the equity shares of the company.

- (3) The statement referred to in sub-rule (2) shall also indicate -
- (i) designation of the employee;
 - (ii) remuneration received;
 - (iii) nature of employment, whether contractual or otherwise;
 - (iv) qualifications and experience of the employee;
 - (v) date of commencement of employment;
 - (vi) the age of such employee;
 - (vii) the last employment held by such employee before joining the company;
 - (viii) the percentage of equity shares held by the employee in the company within the meaning of clause (iii) of sub-rule (2) above; and
 - (ix) whether any such employee is a relative of any director or manager of the company and if so, name of such director or manager:

Provided that the particulars of employees posted and working in a country outside India, not being directors or their relatives, drawing more than sixty lakh rupees per financial year or five lakh rupees per month, as the case may be, as may be decided by the Board, shall not be circulated to the members in the Board's report, but such particulars shall be filed with the Registrar of Companies while filing the financial statement and Board Reports:

Provided further that such particulars shall be made available to any shareholder on a specific request made by him in writing before the date of such Annual General Meeting wherein financial statements for the relevant financial year are proposed to be adopted by shareholders and such particulars shall be made available by the company within three days from the date of receipt of such request from shareholders:

Provided also that, in case of request received even after the date of completion of Annual General Meeting, such particulars shall be made available to the shareholders, within seven days from the date of receipt of such request.

Schedule V

PART II - REMUNERATION

Section I.— Remuneration payable by companies having profits:

III.864 Auditing Pronouncements

Subject to the provisions of section 197, a company having profits in a financial year may pay remuneration to a managerial person or persons not exceeding the limits specified in such section.

Section II.— Remuneration payable by companies having no profit or inadequate profit without Central Government approval:

Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits under (A) and (B) given below:—

(A):

(1)	(2)
Where the effective capital is	Limit of yearly remuneration payable shall not exceed (Rupees)
(i) Negative or less than 5 crores	30 lakhs
(ii) 5 crores and above but less than 100 crores	42 lakhs
(iii) 100 crores and above but less than 250 crores	60 lakhs
(iv) 250 crores and above	60 lakhs <i>plus</i> 0.01% of the effective capital in excess of Rs. 250 crores:

Provided that the above limits shall be doubled if the resolution passed by the shareholders is a special resolution.

Explanation.—It is hereby clarified that for a period less than one year, the limits shall be pro-rated.

(B) In the case of a managerial person who was not a security holder holding securities of the company of nominal value of rupees five lakh or more or an employee or a director of the company or not related to any director or promoter at any time during the two years prior to his appointment as a managerial person, — 2.5% of the current relevant profit:

Provided that if the resolution passed by the shareholders is a special resolution, this limit shall be doubled:

Provided further that the limits specified under this section shall apply, if—

- (i) payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under sub-section (1) of section 178 also by the Nomination and Remuneration Committee;
- (ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person;
- (iii) a special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding three years;
- (iv) a statement along with a notice calling the general meeting referred to in clause (iii) is given to the shareholders containing the following information, namely:—

I. General Information:

- (1) Nature of industry
- (2) Date or expected date of commencement of commercial production
- (3) In case of new companies, expected date of commencement of activities as per project approved by financial institutions appearing in the prospectus
- (4) Financial performance based on given indicators
- (5) Foreign investments or collaborations, if any.

II. Information about the appointee:

- (1) Background details
- (2) Past remuneration
- (3) Recognition or awards
- (4) Job profile and his suitability
- (5) Remuneration proposed
- (6) Comparative remuneration profile with respect to industry, size of the company, profile of the position and person (in case of expatriates the relevant details would be with respect to the country of his origin)

III.866 Auditing Pronouncements

- (7) Pecuniary relationship directly or indirectly with the company, or relationship with the managerial personnel, if any.

III. Other information:

- (1) Reasons of loss or inadequate profits
- (2) Steps taken or proposed to be taken for improvement
- (3) Expected increase in productivity and profits in measurable terms.

IV. Disclosures:

The following disclosures shall be mentioned in the Board of Director's report under the heading "Corporate Governance", if any, attached to the financial statement:—

- (i) all elements of remuneration package such as salary, benefits, bonuses, stock options, pension, etc., of all the directors;
- (ii) details of fixed component and performance linked incentives along with the performance criteria;
- (iii) service contracts, notice period, severance fees;
- (iv) stock option details, if any, and whether the same has been issued at a discount as well as the period over which accrued and over which exercisable.

Section III.— Remuneration payable by companies having no profit or inadequate profit without Central Government approval in certain special circumstances:

In the following circumstances a company may, without the Central Government approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:—

- (a) where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under section 197.
- (b) where the company—
 - (i) is a newly incorporated company, for a period of seven years from the date of its incorporation, or
 - (ii) is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction or National Company Law

Tribunal, for a period of five years from the date of sanction of scheme of revival, it may pay remuneration up to two times the amount permissible under Section II.

- (c) where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal:

Provided that the limits under this Section shall be applicable subject to meeting all the conditions specified under Section II and the following additional conditions:—

- (i) except as provided in para (a) of this Section, the managerial person is not receiving remuneration from any other company;
- (ii) the auditor or Company Secretary of the company or where the company has not appointed a Secretary, a Secretary in whole-time practice, certifies that all secured creditors and term lenders have stated in writing that they have no objection for the appointment of the managerial person as well as the quantum of remuneration and such certificate is filed along with the return as prescribed under sub-section (4) of section 196.
- (iii) the auditor or Company Secretary or where the company has not appointed a secretary, a secretary in whole-time practice certifies that there is no default on payments to any creditors, and all dues to deposit holders are being settled on time.
- (d) a company in a Special Economic Zone as notified by Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India, and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in any financial year, may pay remuneration up to Rs. 2,40,00,000 per annum.

Section IV.— Perquisites not included in managerial remuneration:

1. A managerial person shall be eligible for the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II and Section III:—

- (a) contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income-tax Act, 1961(43 of 1961);
- (b) gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and
- (c) encashment of leave at the end of the tenure.

III.868 Auditing Pronouncements

2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II or Section III—

- (a) *Children's education allowance:* In case of children studying in or outside India, an allowance limited to a maximum of Rs. 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.
- (b) *Holiday passage for children studying outside India or family staying abroad:*
Return holiday passage once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay abroad to India if they are not residing in India, with the managerial person.
- (c) *Leave travel concession:* Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

Explanation I.— For the purposes of Section II of this Part, "effective capital" means the aggregate of the paid-up share capital (excluding share application money or advances against shares); amount, if any, for the time being standing to the credit of share premium account; reserves and surplus (excluding revaluation reserve); long-term loans and deposits repayable after one year (excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short-term arrangements) as reduced by the aggregate of any investments (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities), accumulated losses and preliminary expenses not written off.

Explanation II.— (a) Where the appointment of the managerial person is made in the year in which company has been incorporated, the effective capital shall be calculated as on the date of such appointment;

- (b) In any other case the effective capital shall be calculated as on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.

Explanation III.— For the purposes of this Schedule, "family" means the spouse, dependent children and dependent parents of the managerial person.

Explanation IV.— The Nomination and Remuneration Committee while approving the remuneration under Section II or Section III, shall—

- (a) take into account, financial position of the company, trend in the industry, appointee's qualification, experience, past performance, past remuneration, etc.;
- (b) be in a position to bring about objectivity in determining the remuneration package while striking a balance between the interest of the company and the shareholders.

Explanation V.— For the purposes of this Schedule, “negative effective capital” means the effective capital which is calculated in accordance with the provisions contained in *Explanation I* of this Part is less than zero.

Explanation VI.— For the purposes of this Schedule:—

- (A) “current relevant profit” means the profit as calculated under section 198 but without deducting the excess of expenditure over income referred to in sub-section 4(l) thereof in respect of those years during which the managerial person was not an employee, director or shareholder of the company or its holding or subsidiary companies.
- (B) “Remuneration” means remuneration as defined in clause (78) of section 2 and includes reimbursement of any direct taxes to the managerial person.

Section V. —Remuneration payable to a managerial person in two companies:

Subject to the provisions of sections I to IV, a managerial person shall draw remuneration from one or both companies, provided that the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from any one of the companies of which he is a managerial person.

PART III

Provisions applicable to Parts I and II of this Schedule

1. The appointment and remuneration referred to in Part I and Part II of this Schedule shall be subject to approval by a resolution of the shareholders in general meeting.
2. The auditor or the Secretary of the company or where the company is not required to appoint a Secretary, a Secretary in whole-time practice shall certify that the requirement of this Schedule have been complied with and such certificate shall be incorporated in the return filed with the Registrar under sub-section (4) of section 196.

PART IV

The Central Government may, by notification, exempt any class or classes of companies from any of the requirements contained in this Schedule.

Text of Nidhi Rules, 2014

1. **Short title and commencement.**—(1) These Rules may be called Nidhi Rules, 2014. (2) They shall come into force on the 1st day of April, 2014.
2. **Application.**—These rules shall apply to,—
 - (a) every company which had been declared as a Nidhi or Mutual Benefit Society under sub-section (1) of Section 620A of the Companies Act, 1956;
 - (b) every company functioning on the lines of a Nidhi company or Mutual Benefit Society but has either not applied for or has applied for and is awaiting notification to be a Nidhi or Mutual Benefit Society under sub-section (1) of Section 620A of the Companies Act, 1956; and
 - (c) every company incorporated as a Nidhi pursuant to the provisions of Section 406 of the Act.
3. **Definitions.**—(1) In these rules, unless the context otherwise requires,—
 - (a) “Act” means the Companies Act, 2013 (18 of 2013);
 - (b) “Doubtful Asset” means a borrowal account which has remained a Non-performing asset for more than two years but less than three years;
 - (c) “Loss Asset” means a borrowal account which has remained a Non-performing asset for more than three years or where in the opinion of the Board, a shortfall in the recovery of the loan account is expected because the documents executed may become invalid if subjected to legal process or for any other reason;
 - (d) “Net Owned Funds” means the aggregate of paid up equity share capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet:

Provided that the amount representing the proceeds of issue of preference shares shall not be included for calculating Net Owned Funds.
 - (e) “Non-Performing Asset” means a borrowal account in respect of which interest income or instalment of loan towards re payment of principal amount has remained unrealised for twelve months;
 - (f) “Standard Asset” means the asset in respect of which no default in re-payment of principal or payment of interest has occurred or is perceived and

which has neither shown signs of any problem relating to re-payment of principal sum or interest nor does it carry more than normal risk attached to the business;

- (g) “Sub-Standard Asset” means a borrowal account which is a Non-performing asset:

Provided that reschedulement or re-negotiation or re-phasing of the loan instalment or interest payment shall not change the classification of an asset unless the borrowal account has satisfactorily performed for at least twelve months after such reschedulement or renegotiation or rephasing.

- (2) Words and expressions used herein, but not defined in these rules and defined in the Act or in the Companies (Specification of definitions details) Rules, 2014 shall have the same meaning as assigned to them in the Act or in the said Rules.
- 4. Incorporation and incidental matters.—**(1) A Nidhi to be incorporated under the Act shall be a public company and shall have a minimum paid up equity share capital of five lakh rupees.
- (2) On and after the commencement of the Act, no Nidhi shall issue preference shares.
- (3) If preference shares had been issued by a Nidhi before the commencement of this Act, such preference shares shall be redeemed in accordance with the terms of issue of such shares.
- (4) Except as provided under the proviso to sub-rule (e) to rule 6, no Nidhi shall have any object in its Memorandum of Association other than the object of cultivating the habit of thrift and savings amongst its members, receiving deposits from, and lending to, its members only, for their mutual benefit.
- (5) Every Company incorporated as a “Nidhi” shall have the last words ‘Nidhi Limited’ as part of its name.
- 5. Requirements for minimum number of members, net owned fund etc.—**(1) Every Nidhi shall, within a period of one year from the commencement of these rules, ensure that it has—
- (a) not less than two hundred members;
- (b) Net Owned Funds of ten lakh rupees or more;
- (c) unencumbered term deposits of not less than ten per cent of the outstanding deposits as specified in rule 14; and

III.872 Auditing Pronouncements

- (d) ratio of Net Owned Funds to deposits of not more than 1:20.
- (2) Within ninety days from the close of the first financial year after its incorporation and where applicable, the second financial year, Nidhi shall file a return of statutory compliances in Form NDH-1 along with such fee as provided in Companies (Registration Offices and Fees) Rules, 2014 with the Registrar duly certified by a company secretary in practice or a chartered accountant in practice or a cost accountant in practice.
- (3) If a Nidhi is not complying with clauses (a) or (d) of sub-rule (1) above, it shall within thirty days from the close of the first financial year, apply to the Regional Director in Form NDH-2 along with fee specified in Companies (Registration Offices and Fees) Rules, 2014 for extension of time and the Regional Director may consider the application and pass orders within thirty days of receipt of the application.

Explanation.—For the purpose of this rule “Regional Director” means the person appointed by the Central Government in the Ministry of Corporate Affairs as a Regional Director;

- (4) If the failure to comply with sub-rule (1) of this rule extends beyond the second financial year, Nidhi shall not accept any further deposits from the commencement of the second financial year till it complies with the provisions contained in sub-rule (1), besides being liable for penal consequences as provided in the Act.

6. General restrictions or prohibitions.—No Nidhi shall—

- (a) carry on the business of chit fund, hire purchase finance, leasing finance, insurance or acquisition of securities issued by any body corporate;
- (b) issue preference shares, debentures or any other debt instrument by any name or in any form whatsoever;
- (c) open any current account with its members;
- (d) acquire another company by purchase of securities or control the composition of the Board of Directors of any other company in any manner whatsoever or enter into any arrangement for the change of its management, unless it has passed a special resolution in its general meeting and also obtained the previous approval of the Regional Director having jurisdiction over such Nidhi;

Explanation.—For the purposes of this sub-rule, “control” shall have the same meaning assigned to it in clause (27) of section 2 of the Act;

- (e) carry on any business other than the business of borrowing or lending in its own name:

Provided that Nidhis which have adhered to all the provisions of these rules may provide locker facilities on rent to its members subject to the rental income from such facilities not exceeding twenty per cent of the gross income of the Nidhi at any point of time during a financial year.

- (f) accept deposits from or lend to any person, other than its members;
- (g) pledge any of the assets lodged by its members as security;
- (h) take deposits from or lend money to any body corporate;
- (i) enter into any partnership arrangement in its borrowing or lending activities;
- (j) issue or cause to be issued any advertisement in any form for soliciting deposit:

Provided that private circulation of the details of fixed deposit Schemes among the members of the Nidhi carrying the words "for private circulation to members only" shall not be considered to be an advertisement for soliciting deposits.

- (k) pay any brokerage or incentive for mobilising deposits from members or for deployment of funds or for granting loans.

7. **Share capital and allotment.**—(1) Every Nidhi shall issue equity shares of the nominal value of not less than ten rupees each:

Provided that this requirement shall not apply to a company referred to in sub-rules (a) and (b) of rule 2.

- (2) No service charge shall be levied for issue of shares.
- (3) Every Nidhi shall allot to each deposit holder at least a minimum of ten equity shares or shares equivalent to one hundred rupees:

Provided that a savings account holder and a recurring deposit account holder shall hold at least one equity share of rupees ten.

8. **Membership.**—(1) A Nidhi shall not admit a body corporate or trust as a member.

- (2) Except as otherwise permitted under these rules, every Nidhi shall ensure that its membership is not reduced to less than two hundred members at any time.

III.874 Auditing Pronouncements

- (3) A minor shall not be admitted as a member of Nidhi:
- Provided that deposits may be accepted in the name of a minor, if they are made by the natural or legal guardian who is a member of Nidhi.
9. **Net owned funds.**—Every Nidhi shall maintain Net Owned Funds (excluding the proceeds of any preference share capital) of not less than ten lakh rupees or such higher amount as the Central Government may specify from time to time.
10. **Branches.**—(1) A Nidhi may open branches, only if it has earned net profits after tax continuously during the preceding three financial years.
- (2) Subject to the provisions contained in sub-rule (1), a Nidhi may open up to three branches within the district.
- (3) If a Nidhi proposes to open more than three branches within the district or any branch outside the district, it shall obtain the prior permission of the Regional Director and an intimation is to be given to the Registrar about opening of every branch within thirty days of such opening.
- (4) No Nidhi shall open branches or collection centres or offices or deposit centres, or by whatever name called outside the State where its registered office is situated.
- (5) No Nidhi shall open branches or collection centres or offices or deposit centres, or by whatever name called unless financial statement and annual return (up to date) are filed with the Registrar.
- (6) A Nidhi shall not close any branch unless it—
- (a) publishes an advertisement in a newspaper in vernacular language in the place where it carries on business at least thirty days prior to such closure, informing the public about such closure;
- (b) fixes a copy of such advertisement or a notice informing such closure of the branch on the notice board of Nidhi for a period of at least thirty days from the date on which advertisement was published under clause (a); and
- (c) gives an intimation to the Registrar within thirty days of such closure.
11. **Acceptance of deposits by Nidhis.**—(1) A Nidhi shall not accept deposits exceeding twenty times of its Net Owned Funds (NOF) as per its last audited financial statements.

- (2) In the case of companies covered under clauses (a) and (b) of rule 2 and existing on or before 26th July, 2001 and which have accepted deposits in excess of the aforesaid limits, the same shall be restored to the prescribed limit by increasing the Net Owned Funds position or alternatively by reducing the deposit according to the table given below:

TABLE

<i>Ratio of Net Owned Funds to Deposits (as on 31.3. 2013)</i>	<i>Date by which the company has to achieve prescribed ceiling of 1:20</i>
a) More than 1:20 but up to 1:35	By 31.3. 2015
b) More than 1:35 but up to 1:45	By 31.3. 2016
c) More than 1:45	By 31.3. 2017

- (3) The companies which are covered under the Table in sub-rule (2) above shall not accept fresh deposits or renew existing deposits if such acceptance or renewal leads to violation of the prescribed ratio.
- (4) The ratio specified in sub-rule (2) above shall also apply to incremental deposits.
12. **Application form for deposit.**—(1) Every application form for placing a deposit with a Nidhi shall contain the following particulars, namely:—
- Name of Nidhi;
 - Date of incorporation of Nidhi;
 - The business carried on by Nidhi with details of branches, if any;
 - Brief particulars of the management of Nidhi (name, addresses and occupation of the directors, including DIN);
 - Net profits of Nidhi before and after making provision for tax for the preceding three financial years;
 - Dividend declared by Nidhi during the preceding three financial years;
 - Mode of repayment of the deposit;
 - Maturity period of the deposit;
 - Interest payable on the deposit;

III.876 Auditing Pronouncements

- (j) The rate of interest payable to the depositor in case the depositor withdraws the deposit prematurely;
 - (k) The terms and conditions subject to which the deposit may be accepted or renewed;
 - (l) A summary of the financials of the company as per the latest two audited financial statements as given below:
 - (i) Net Owned Funds
 - (ii) Deposits accepted
 - (iii) Deposits repaid
 - (iv) Deposits claimed but remaining unpaid
 - (v) Loans disbursed against—
 - (a) immovable property;
 - (b) deposits; and
 - (c) gold and jewellery
 - (vi) Profit before tax
 - (vii) Provision for tax
 - (viii) Profit after tax
 - (ix) Dividend per share
 - (m) any other special features or terms and conditions subject to which the deposit is accepted or renewed.
- (2) The application form shall also contain the following statements, namely:—
- (a) in case of Non-payment of the deposit or part thereof as per the terms and conditions of such deposit, the depositor may approach the Registrar of companies having jurisdiction over Nidhi; (b) in case of any deficiency of Nidhi in servicing its depositors, the depositor may approach the National Consumers Disputes Redressal Forum, the State Consumers Disputes Redressal Forum or District Consumers Disputes Redressal Forum, as the case may be, for redressal of his relief;

- (c) a declaration by the Board of Directors to the effect that the financial position of Nidhi as disclosed and the representations made in the application form are true and correct and that Nidhi has complied with all the applicable rules;
 - (d) a statement to the effect that the Central Government does not undertake any responsibility for the financial soundness of Nidhi or for the correctness of any of the statement or the representations made or opinions expressed by Nidhi;
 - (e) the deposits accepted by Nidhi are not insured and the repayment of deposits is not guaranteed by either the Central Government or the Reserve Bank of India; and
 - (f) a verification clause by the depositor stating that he had read and understood the financial and other particulars furnished and representations made by Nidhi in his application form and after careful consideration he is making the deposit with Nidhi at his own risk and volition.
- (3) Every Nidhi shall obtain proper introduction of new depositors before opening their accounts or accepting their deposits and keep on its record the evidence on which it has relied upon for the purpose of such introduction.
- (4) For the purposes of introduction of depositors, a Nidhi shall obtain documentary evidence of the depositor in the form of proof of identity and address as under:
- (a) Proof of Identity (any one of the following)
 - (i) Passport
 - (ii) Unique Identification Number
 - (iii) Income-tax PAN card
 - (iv) Elector Photo Identity Card
 - (v) Driving licence
 - (vi) Ration card
 - (b) Proof of address (any one of the following)
 - (i) Passport
 - (ii) Unique Identification Number
 - (iii) Elector Photo Identity Card
 - (iv) Driving licence
 - (v) Ration card

III.878 Auditing Pronouncements

- (vi) Telephone bill
- (vii) Bank account statement
- (viii) Electricity bill

(documents referred to serial numbers (vi), (vii) and (viii) above shall not be more than two months old)

- 13. Deposits.**—(1) The fixed deposits shall be accepted for a minimum period of six months and a maximum period of sixty months.
- (2) Recurring deposits shall be accepted for a minimum period of twelve months and a maximum period of sixty months.
 - (3) In case of recurring deposits relating to mortgage loans, the maximum period of recurring deposits shall correspond to the repayment period of such loans granted by Nidhi.
 - (4) The maximum balance in a savings deposit account at any given time qualifying for interest shall not exceed one lakh rupees at any point of time and the rate of interest shall not exceed two per cent above the rate of interest payable on savings bank account by nationalised banks.
 - (5) A Nidhi may offer interest on fixed and recurring deposits at a rate not exceeding the maximum rate of interest prescribed by the Reserve Bank of India which the Non-Banking Financial Companies can pay on their public deposits.
 - (6) A fixed deposit account or a recurring deposit account shall be foreclosed by the depositor subject to the following conditions, namely:—
 - (a) a Nidhi shall not repay any deposit within a period of three months from the date of its acceptance;
 - (b) where at the request of the depositor, a Nidhi repays any deposit after a period of three months, the depositor shall not be entitled to any interest up to six months from the date of deposit;
 - (c) where at the request of the depositor, a Nidhi makes repayment of a deposit before the expiry of the period for which such deposit was accepted by Nidhi, the rate of interest payable by Nidhi on such deposit shall be reduced by two per cent from the rate which Nidhi would have ordinarily paid, had the deposit been accepted for the period for which such deposit had run:

Provided that in the event of death of a depositor, the deposit may be repaid prematurely to the surviving depositor or depositors in the case of joint holding with survivor clause, or to the nominee or to legal heir with interest up to the date of repayment at the rate which the company would have ordinarily paid, had such deposit been accepted for the period for which such deposit had run.

- 14. Un-encumbered term deposits.**—Every Nidhi shall invest and continue to keep invested, in unencumbered term deposits with a Scheduled commercial bank (other than a co-operative bank or a regional rural bank), or post office deposits in its own name an amount which shall not be less than ten per cent of the deposits outstanding at the close of business on the last working day of the second preceding month:

Provided that in cases of unforeseen commitments, temporary withdrawal may be permitted with the prior approval of the Regional Director for the purpose of repayment to depositors, subject to such conditions and time limit which may be specified by the Regional Director to ensure restoration of the prescribed limit of ten per cent.

- 15. Loans.**—(1) A Nidhi shall provide loans only to its members.
- (2) The loans given by a Nidhi to a member shall be subject to the following limits, namely:—
- (a) two lakh rupees, where the total amount of deposits of such Nidhi from its members is less than two crore rupees;
 - (b) seven lakh fifty thousand rupees, where the total amount of deposits of such Nidhi from its members is more than two crore rupees but less than twenty crore rupees;
 - (c) twelve lakh rupees, where the total amount of deposits of such Nidhi from its members is more than twenty crore rupees but less than fifty crore rupees; and
 - (d) fifteen lakh rupees, where the total amount of deposits of such Nidhi from its members is more than fifty crore rupees:

Provided that where a Nidhi has not made profits continuously in the three preceding financial years, it shall not make any fresh loans exceeding fifty per cent of the maximum amounts of loans specified in clauses (a), (b), (c) or (d).

III.880 Auditing Pronouncements

Provided further that, a member shall not be eligible for any further loan if he has borrowed any earlier loan from the Nidhi and has defaulted in repayment of such loan.

(3) For the purposes of sub-rule (2), the amount of deposits shall be calculated on the basis of the last audited annual financial statements.

(4) A Nidhi shall give loans to its members only against the following securities, namely:—

(a) gold, silver and jewellery:

Provided that the re-payment period of such loan shall not exceed one year.

(b) immovable property:

Provided that the total loans against immovable property [excluding mortgage loans granted on the security of property by registered mortgage, being a registered mortgage under section 69 of the Transfer of Property Act, 1882 (IV of 1882)] shall not exceed fifty per cent of the overall loan outstanding on the date of approval by the board, the individual loan shall not exceed fifty per cent of the value of property offered as security and the period of repayment of such loan shall not exceed seven years.

(c) fixed deposit receipts, National Savings Certificates, other Government Securities and insurance policies:

Provided that such securities duly discharged shall be pledged with Nidhi and the maturity date of such securities shall not fall beyond the loan period or one year whichever is earlier:

Provided further that in the case of loan against fixed deposits, the period of loan shall not exceed the unexpired period of the fixed deposits.

16. Rate of interest.—The rate of interest to be charged on any loan given by a Nidhi shall not exceed seven and half per cent above the highest rate of interest offered on deposits by Nidhi and shall be calculated on reducing balance method:

Provided that Nidhi shall charge the same rate of interest on the borrowers in respect of the same class of loans and the rates of interest of all classes of loans shall be prominently displayed on the notice board at the registered office and each branch office of Nidhi.

17. Rules relating to Directors.—(1) The Director shall be a member of Nidhi.

- (2) The Director of a Nidhi shall hold office for a term up to ten consecutive years on the Board of Nidhi.
 - (3) The Director shall be eligible for re-appointment only after the expiration of two years of ceasing to be a Director.
 - (4) Where the tenure of any Director in any case had already been extended by the Central Government, it shall terminate on expiry of such extended tenure.
 - (5) The person to be appointed as a Director shall comply with the requirements of sub-section (4) of Section 152 of the Act and shall not have been disqualified from appointment as provided in section 164 of the Act.
- 18. Dividend.**- A Nidhi shall not declare dividend exceeding twenty five per cent or such higher amount as may be specifically approved by the Regional Director for reasons to be recorded in writing and further subject to the following conditions, namely:—
- (a) an equal amount is transferred to General Reserve;
 - (b) there has been no default in repayment of matured deposits and interest; and
 - (c) it has complied with all the rules as applicable to Nidhis.
- 19. Auditor.**—(1) No Nidhi shall appoint or re-appoint an individual as auditor for more than one term of five consecutive years.
- (2) No Nidhi shall appoint or re-appoint an audit firm as auditor for more than two terms of five consecutive years: Provided that an auditor (whether an individual or an audit firm) shall be eligible for subsequent appointment after the expiration of two years from the completion of his or its term:
- Explanation: For the purposes of this proviso:
- (i) in case of an auditor (whether an individual or audit firm), the period for which he or it has been holding office as auditor prior to the commencement of these rules shall be taken into account in calculating the period of five consecutive years or ten consecutive years, as the case may be;
 - (ii) appointment includes re-appointment.
- 20. Prudential norms.**—(1) Every Nidhi shall adhere to the prudential norms for revenue recognition and classification of assets in respect of mortgage loans or jewel loans as contained hereunder.

III.882 Auditing Pronouncements

- (2) Income including interest or any other charges on non-performing assets shall be recognised only when it is actually realised and any such income recognised before the asset became non-performing and which remains unrealised in a year shall be reversed in the profit and loss account of the immediately succeeding year.
- (3) (a) In respect of mortgage loans, the classification of assets and the provisioning required shall be as under:

NATURE OF ASSET	PROVISION REQUIRED
Standard Asset	No provision
Sub-standard Asset	10% of the aggregate outstanding amount
Doubtful Asset	25% of the aggregate outstanding amount
Loss Asset	100% of the aggregate outstanding amount

Provided that a Nidhi may make provision for exceeding the percentage specific herein.

- (b) The estimated realisable value of the collateral security to which a Nidhi has valid recourse may be reduced from the aggregate outstanding amount, if the proceedings for the sale of the mortgaged property have been initiated in a court of law within the previous two years of the interest, income or instalment remaining unrealised.
- (4) In case of companies which were incorporated on or before 26-07-2001, such companies shall make provisions in respect of loans disbursed and outstanding as on 31-03-2002 for income reversal and non-performing assets as per table given below:

For the year ended	Extent of provision
31-03-2015	Un-provided balance on equal basis over the three years as specified in the preceding column.
31-03-2016	
31-03-2017	

- (5) (a) The Notes on the financial statements of a year shall disclose-
- (i) the total amount of provisions, if any, to be made on account of income reversal and non-performing assets remaining unrealised;
- (ii) the cumulative amount provided till the previous year;

- (iii) the amount provided in the current year; and
- (iv) the balance amount to be provided.
- (b) Such disclosure shall continue to be made until the entire amount to be provided has been provided for.
- (6) In respect of loans against gold or jewellery—
 - (a) the aggregate amount of loan outstanding against the security of gold or jewellery shall either be recovered or renewed within three months from the due date of repayment;
 - (b) if the loan is not recovered or renewed and the security is not sold within the aforesaid period of three months, the company shall make provision in the current year's financial statements to the extent of unrealised amount or the aggregate outstanding amount of loan including interest as applicable;
 - (c) no income shall be recognised on such loans outstanding after the expiry of the three months period specified in (a) above or sale of gold or jewellery, whichever is earlier; and
 - (d) the loan to value ratio shall not exceed 80 per cent.

Explanation.- For the purposes of this rule, the term 'loan to value ratio' means the ratio between the amount of loan given and the value of gold or jewellery against which such loan is given.

- 21. **Filing of half yearly return.**—Every company covered under rule 2 shall file half yearly return with the Registrar in Form NDH-3 along with such fee as provided in Companies (Registration Offices and Fees) Rules, 2014 within thirty days from the conclusion of each half year duly certified by a company secretary in practice or chartered accountant in practice or cost accountant in practice.
- 22. **Auditor's certificate.**—The Auditor of the company shall furnish a certificate every year to the effect that the company has complied with all the provisions contained in the rules and such certificate shall be annexed to the audit report and in case of non-compliance, he shall specifically state the rules which have not been complied with.
- 23. **Power to enforce compliance.**—(1) For the purposes of enforcing compliance with these rules, the Registrar of companies may call for such information or returns from Nidhi as he deems necessary and may engage the services of chartered

III.884 Auditing Pronouncements

accountants, company secretaries in practice, cost accountants, or any firm thereof from time to time for assisting him in the discharge of his duties.

- (2) In respect of any Nidhi which has violated these rules or has failed to function in terms of the Memorandum and Articles of Association, the concerned Regional Director may appoint a Special Officer to take over the management of Nidhi and such Special Officer shall function as per the guidelines given by such Regional Director:

Provided that an opportunity of being heard shall be given to the concerned Nidhi by the Regional Director before appointing any Special Officer.

24. **Penalty for non-compliance.**- If a company falling under rule 2 contravenes any of the provisions of the rules prescribed herein, the company and every officer of the company who is in default shall be punishable with fine which may extend to five thousand rupees, and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first during which the contravention continues.

Appendix IX

Text of Section 42 of the Companies Act, 2013

42. Offer or invitation for subscription of securities on private placement¹⁶.

- (1) Without prejudice to the provisions of section 26, a company may, subject to the provisions of this section, make private placement through issue of a private placement offer letter.
- (2) Subject to sub-section (1), the offer of securities or invitation to subscribe securities, shall be made to such number of persons not exceeding fifty or such higher number as may be prescribed, [excluding qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option as per provisions of clause (b) of sub-section (1) of section 62], in a financial year and on such conditions (including the form and manner of private placement) as may be prescribed.

Explanation I.—If a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than the prescribed number of persons, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognised stock exchange in or outside India, the same shall be deemed to be an

¹⁶ Ministry of Corporate Affairs vide its notification no. GSR 465(E) dated 5th June, 2015 has specified that Section 42 except sub-section (1), explanation (II) to sub-section (2), sub-sections (4), (6), (t), (9) and (10) shall not apply to Nidhis.

offer to the public and shall accordingly be governed by the provisions of Part I of this Chapter.

Explanation II.— For the purposes of this section, the expression—

- (i) "qualified institutional buyer" means the qualified institutional buyer as defined in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 as amended from time to time.
 - (ii) "private placement" means any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in this section.
- (3) No fresh offer or invitation under this section shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.
 - (4) Any offer or invitation not in compliance with the provisions of this section shall be treated as a public offer and all provisions of this Act, and the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be required to be complied with.
 - (5) All monies payable towards subscription of securities under this section shall be paid through cheque or demand draft or other banking channels but not by cash.
 - (6) A company making an offer or invitation under this section shall allot its securities within sixty days from the date of receipt of the application money for such securities and if the company is not able to allot the securities within that period, it shall repay the application money to the subscribers within fifteen days from the date of completion of sixty days and if the company fails to repay the application money within the aforesaid period, it shall be liable to repay that money with interest at the rate of twelve per cent. per annum from the expiry of the sixtieth day:

Provided that monies received on application under this section shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than—
 - (a) for adjustment against allotment of securities; or
 - (b) for the repayment of monies where the company is unable to allot securities.
 - (7) All offers covered under this section shall be made only to such persons whose names are recorded by the company prior to the invitation to subscribe, and that such persons shall receive the offer by name, and that a complete record of such offers shall be kept by the company in such manner as may be prescribed and

III.886 Auditing Pronouncements

complete information about such offer shall be filed with the Registrar within a period of thirty days of circulation of relevant private placement offer letter.

- (8) No company offering securities under this section shall release any public advertisements or utilise any media, marketing or distribution channels or agents to inform the public at large about such an offer.
- (9) Whenever a company makes any allotment of securities under this section, it shall file with the Registrar a return of allotment in such manner as may be prescribed, including the complete list of all security-holders, with their full names, addresses, number of securities allotted and such other relevant information as may be prescribed.
- (10) If a company makes an offer or accepts monies in contravention of this section, the company, its promoters and directors shall be liable for a penalty which may extend to the amount involved in the offer or invitation or two crore rupees, whichever is higher, and the company shall also refund all monies to subscribers within a period of thirty days of the order imposing the penalty.

Appendix X

Rule 14 of the Companies (Prospectus & Allotment of Securities) Rules, 2014

Rule 14 of The Companies (Prospectus and Allotment of Securities) Rules, 2014, as amended by notification dated 30.6.2014

14. Private Placement.—

- (1) (a) For the purposes of sub-section (1) of section 42, a company may make an offer or invitation to subscribe to securities through issue of a private placement offer letter in Form PAS-4.

(b) A private placement offer letter shall be accompanied by an application form serially numbered and addressed specifically to the person to whom the offer is made and shall be sent to him, either in writing or in electronic mode, within thirty days of recording the names of such persons in accordance with sub-section (7) of section 42:

Provided that no person other than the person so addressed in the application form shall be allowed to apply through such application form and any application not conforming to this condition shall be treated as invalid.

- (2) A company shall not make a private placement of its securities unless –

(a) the proposed offer of securities or invitation to subscribe securities has been previously approved by the shareholders of the company, by a Special Resolution, for each of the Offers or Invitations:

Provided that in the explanatory statement annexed to the notice for the general meeting the basis or justification for the price (including premium, if any) at which the offer or invitation is being made shall be disclosed:

Provided further that in case of offer or invitation for non-convertible debentures, it shall be sufficient if the company passes a previous special resolution only once in a year for all the offers or invitation for such debentures during the year.

Provided also that in case of an offer or invitation for non convertible debenture referred to in the second proviso, made within a period of six months from the date of commencement of these rules, the special resolution referred to in the second proviso may be passed within the said period of six months from the date of commencement of these rules.

(b) such offer or invitation shall be made to not more than two hundred persons in the aggregate in a financial year:

Provided that any offer or invitation made to qualified institutional buyers, or to employees of the company under a scheme of employees stock option as per provisions of clause (b) of sub-section (1) of section 62 shall not be considered while calculating the limit of two hundred persons;

Explanation.– For the purposes of this sub-rule, it is hereby clarified that –

(i) the restrictions under sub-clause (b) would be reckoned individually for each kind of security that is equity share, preference share or debenture;

(ii) the requirement of provisions of sub-section (3) of section 42 shall apply in respect of offer or invitation of each kind of security and no offer or invitation of another kind of security shall be made unless allotments with respect to offer or invitation made earlier in respect of any other kind of security is completed;

(c) the value of such offer or invitation per person shall be with an investment size of not less than twenty thousand rupees of face value of the securities;

(d) the payment to be made for subscription to securities shall be made from the bank account of the person subscribing to such securities and the company shall keep the record of the Bank account from where such payments for subscriptions have been received:

III.888 Auditing Pronouncements

Provided that monies payable on subscription to securities to be held by joint holders shall be paid from the bank account of the person whose name appears first in the application.

- (3) The company shall maintain a complete record of private placement offers in Form PAS-5:

Provided that a copy of such record along with the private placement offer letter in Form PAS-4 shall be filed with the Registrar with fee as provided in Companies (Registration Offices and Fees) Rules, 2014 and where the company is listed, with the Securities and Exchange Board within a period of thirty days of circulation of the private placement offer letter.

Explanation.- For the purpose of this rule, it is hereby clarified that the date of private placement offer letter shall be deemed to be the date of circulation of private placement offer letter.

- (4) A return of allotment of securities under section 42 shall be filed with the Registrar within thirty days of allotment in Form PAS-3 and with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014 along with a complete list of all security holders containing-

- (i) the full name, address, Permanent Account Number and E-mail ID of such security holder;
- (ii) the class of security held;
- (iii) the date of allotment of security ;
- (iv) the number of securities held, nominal value and amount paid on such securities; and particulars of consideration received if the securities were issued for consideration other than cash.

- (5) The provisions of clauses (b) and (c) of sub-rule (2) shall not be applicable to –

- (a) non-banking financial companies which are registered with the Reserve Bank of India under Reserve Bank of India Act, 1934; and
- (b) housing finance companies which are registered with the National Housing Bank under National Housing Bank Act, 1987,

if they are complying with regulations made by Reserve Bank of India or National Housing Bank in respect of offer or invitation to be issued on private placement basis:

Provided that such companies shall comply with sub-clauses (b) and (c) of

sub-rule (2) in case the Reserve Bank of India or the National Housing Bank have not specified similar regulations.

Appendix XI

Text of Section 45-IA of the Reserve Bank of India Act, 1934

45-IA. Requirement of Registration and Net Owned Fund

- (1) Notwithstanding anything contained in this Chapter or in any other law for the time being in force, no non-banking financial company shall commence or carry on the business of a non-banking financial institution without—
 - (a) obtaining a certificate of registration issued under this Chapter; and
 - (b) having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding two hundred lakh rupees, (Rs. 200 Lakhs since April 1999) as the Bank may, by notification in the Official Gazette, specify.
- (2) Every non-banking financial company shall make an application for registration to the Bank in such form as the Bank may specify:

Provided that a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 shall make an application for registration to the Bank before the expiry of six months from such commencement and notwithstanding anything contained in sub-section (1) may continue to carry on the business of a non-banking financial institution until a certificate of registration is issued to it or rejection of application for registration is communicated to it.

- (3) Notwithstanding anything contained in sub-section (1), a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 and having a net owned fund of less than twenty-five lakh rupees may, for the purpose of enabling such company to fulfil the requirement of the net owned fund, continue to carry on the business of a non-banking financial institution—
 - (i) for a period of three years from such commencement; or
 - (ii) for such further period as the Bank may, after recording the reasons in writing for so doing, extend, subject to the condition that such company shall, within three months of fulfilling the requirement of the net owned fund, inform the Bank about such fulfilment:

III.890 Auditing Pronouncements

Provided that the period allowed to continue business under this sub-section shall in no case exceed six years in the aggregate.

- (4) The Bank may, for the purpose of considering the application for registration, require to be satisfied by an inspection of the books of the non-banking financial company or otherwise that the following conditions are fulfilled:—
 - (a) that the non-banking financial company is or shall be in a position to pay its present or future depositors in full as and when their claims accrue;
 - (b) that the affairs of the non-banking financial company are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;
 - (c) that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the public interest or the interest of its depositors;
 - (d) that the non-banking financial company has adequate capital structure and earning prospects;
 - (e) that the public interest shall be served by the grant of certificate of registration to the non-banking financial company to commence or to carry on the business in India;
 - (f) that the grant of certificate of registration shall not be prejudicial to the operation and consolidation of the financial sector consistent with monetary stability, economic growth and considering such other relevant factors which the Bank may, by notification in the Official Gazette, specify; and
 - (g) any other condition, fulfilment of which in the opinion of the Bank, shall be necessary to ensure that the commencement of or carrying on of the business in India by a non-banking financial company shall not be prejudicial to the public interest or in the interest of the depositors.
- (5) The Bank may, after being satisfied that the conditions specified in sub-section (4) are fulfilled, grant a certificate of registration subject to such conditions which it may consider fit to impose.
- (6) The Bank may cancel a certificate of registration granted to a non-banking financial company under this section if such company—
 - (i) ceases to carry on the business of a non-banking financial institution in India; or

- (ii) has failed to comply with any condition subject to which the certificate of registration had been issued to it; or
- (iii) at any time fails to fulfil any of the conditions referred to in clauses (a) to (g) of sub-section (4); or
- (iv) fails—
 - (a) to comply with any direction issued by the Bank under the provisions of this chapter; or
 - (b) to maintain accounts in accordance with the requirements of any law or any direction or order issued by the Bank under the provisions of this Chapter; or
 - (c) to submit or offer for inspection its books of account and other relevant documents when so demanded by an inspecting authority of the Bank; or
- (v) has been prohibited from accepting deposit by an order made by the Bank under the provisions of this Chapter and such order has been in force for a period of not less than three months:

Provided that before cancelling a certificate of registration on the ground that the non-banking financial company has failed to comply with the provisions of clause (ii) or has failed to fulfil any of the conditions referred to in clause (iii) the Bank, unless it is of the opinion that the delay in cancelling the certificate of registration shall be prejudicial to public interest or the interest of the depositors or the non-banking financial company, shall give an opportunity to such company on such terms as the Bank may specify for taking necessary steps to comply with such provision or fulfillment of such condition;

Provided further that before making any order of cancellation of certificate of registration, such company shall be given a reasonable opportunity of being heard.

- (7) A company aggrieved by the order of rejection of application for registration or cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of rejection or cancellation is communicated to it, to the Central Government and the decision of the Central Government where an appeal has been preferred to it, or of the Bank where no appeal has been preferred, shall be final:

Provided that before making any order of rejection of appeal, such company shall be given a reasonable opportunity of being heard.

Explanation.— For the purposes of this section,—

III.892 Auditing Pronouncements

- (I) “net owned fund” means–
 - (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting therefrom–
 - (i) accumulated balance of loss;
 - (ii) deferred revenue expenditure; and
 - (iii) other intangible assets; and
 - (b) further reduced by the amounts representing–
 - (1) investments of such company in shares of–
 - (i) its subsidiaries;
 - (ii) companies in the same group;
 - (iii) all other non-banking financial companies; and
 - (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,–
 - (i) subsidiaries of such company; and
 - (ii) companies in the same group,
- to the extent such amount exceeds ten per cent of (a) above.
- (II) “subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.

Appendix XII

Text of Sections 73 to 76 of the Companies Act, 2013

Prohibition on acceptance of deposits from public

73. (1) On and after the commencement of this Act, no company shall invite, accept or renew deposits under this Act from the public except in a manner provided under this Chapter:

Provided that nothing in this sub-section shall apply to a banking company and non-banking financial company as defined in the Reserve Bank of India Act, 1934 and to such other company as the Central Government may, after consultation with the Reserve Bank of India, specify in this behalf.

- (2) A company may, subject to the passing of a resolution in general meeting and subject to such rules as may be prescribed in consultation with the Reserve Bank of India, accept deposits from its members on such terms and conditions, including the provision of security, if any, or for the repayment of such deposits with interest, as may be agreed upon between the company and its members, subject to the fulfilment of the following conditions, namely:—
- (a) issuance of a circular to its members including therein a statement showing the financial position of the company, the credit rating obtained, the total number of depositors and the amount due towards deposits in respect of any previous deposits accepted by the company and such other particulars in such form and in such manner as may be prescribed;
 - (b) filing a copy of the circular along with such statement with the Registrar within thirty days before the date of issue of the circular;
 - (c) depositing such sum which shall not be less than fifteen per cent of the amount of its deposits maturing during a financial year and the financial year next following, and kept in a scheduled bank in a separate bank account to be called as deposit repayment reserve account;
 - (d) providing such deposit insurance in such manner and to such extent as maybe prescribed;
 - (e) certifying that the company has not committed any default in the repayment of deposits accepted either before or after the commencement of this Act or payment of interest on such deposits; and
 - (f) providing security, if any for the due repayment of the amount of deposit or the interest thereon including the creation of such charge on the property or assets of the company:

Provided that in case where a company does not secure the deposits or secures such deposits partially, then, the deposits shall be termed as “unsecured deposits” and shall be so quoted in every circular, form, advertisement or in any document related to invitation or acceptance of deposits.

III.894 Auditing Pronouncements

- (3) Every deposit accepted by a company under sub-section (2) shall be repaid with interesting accordance with the terms and conditions of the agreement referred to in that sub-section.
- (4) Where a company fails to repay the deposit or part thereof or any interest thereon under sub-section (3), the depositor concerned may apply to the Tribunal for an order directing the company to pay the sum due or for any loss or damage incurred by him as a result of such non-payment and for such other orders as the Tribunal may deem fit.
- (5) The deposit repayment reserve account referred to in clause (c) of sub-section (2) shall not be used by the company for any purpose other than repayment of deposits.

Repayment of deposits, etc., accepted before commencement of this Act

74. (1) Where in respect of any deposit accepted by a company before the commencement of this Act, the amount of such deposit or part thereof or any interest due thereon remains unpaid on such commencement or becomes due at any time thereafter, the company shall—
 - (a) file, within a period of three months from such commencement or from the date on which such payments, are due, with the Registrar a statement of all the deposits accepted by the company and sums remaining unpaid on such amount with the interest payable thereon along with the arrangements made for such repayment, notwithstanding anything contained in any other law for the time being in force or under the terms and conditions subject to which the deposit was accepted or any scheme framed under any law; and
 - (b) repay within one year from such commencement or from the date on which such payments are due, whichever is earlier.
- (2) The Tribunal may on an application made by the company, after considering the financial condition of the company, the amount of deposit or part thereof and the interest payable thereon and such other matters, allow further time as considered reasonable to the company to repay the deposit.
- (3) If a company fails to repay the deposit or part thereof or any interest thereon within the time specified in sub-section (1) or such further time as may be allowed by the Tribunal under sub-section (2), the company shall, in addition to the payment of the amount of deposit or part thereof and the interest due, be punishable with fine which shall not be less than one crore rupees but which may extend to ten crore rupees and every officer of the company who is in default shall be punishable with imprisonment which may extend to seven years or with fine which shall not be less than twenty-five lakh rupees but which may extend to two crore rupees, or with both.

Damages for fraud

75. (1) Where a company fails to repay the deposit or part thereof or any interest thereon referred to in section 74 within the time specified in sub-section (1) of that section or such further time as may be allowed by the Tribunal under sub-section (2) of that section, and it is proved that the deposits had been accepted with intent to defraud the depositors or for any fraudulent purpose, every officer of the company who was responsible for the acceptance of such deposit shall, without prejudice to the provisions contained in sub-section(3) of that section and liability under section 447, be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by the depositors.
- (2) Any suit, proceedings or other action may be taken by any person, group of persons or any association of persons who had incurred any loss as a result of the failure of the company to repay the deposits or part thereof or any interest thereon.

Acceptance of deposits from Public by certain companies

76. (1) Notwithstanding anything contained in section 73, a public company, having such net worth or turnover as may be prescribed, may accept deposits from persons other than its members subject to compliance with the requirements provided in sub-section (2) of section 73 and subject to such rules as the Central Government may, in consultation with the Reserve Bank of India, prescribe:

Provided that such a company shall be required to obtain the rating (including its net worth, liquidity and ability to pay its deposits on due date) from a recognised credit rating agency for informing the public the rating given to the company at the time of invitation of deposits from the public which ensures adequate safety and the rating shall be obtained for every year during the tenure of deposits:

Provided further that every company accepting secured deposits from the public shall within thirty days of such acceptance, create a charge on its assets of an amount not less than the amount of deposits accepted in favour of the deposit holders in accordance with such rules as may be prescribed.

- (2) The provisions of this Chapter shall, *mutatis mutandis*, apply to the acceptance of deposits from public under this section.

Appendix XIII

Text of the Companies (Acceptance of Deposits) Rules, 2014

III.896 Auditing Pronouncements

1. **Short title, commencement and application.**- (1) These rules may be called the Companies (Acceptance of Deposits) Rules, 2014.
 - (2) They shall come into force on the 1st day of April, 2014.
 - (3) These rules shall apply to a company other than –
 - (i) a banking company;
 - (ii) a non-banking financial company as defined in the Reserve Bank of India Act, 1934 (2 of 1934) registered with the Reserve Bank of India;
 - (iii) a housing finance company registered with the National Housing Bank established under the National Housing Bank Act, 1987 (53 of 1987); and
 - (iv) a company specified by the Central Government under the proviso to sub-section (1) of section 73 of the Act.
2. **Definitions.**- (1) In these rules, unless the context otherwise requires, ___
 - (a) “Act” means the Companies Act, 2013 (18 of 2013);
 - (b) “Annexure” means the Annexure attached to these rules;
 - (c) “deposit” includes any receipt of money by way of deposit or loan or in any other form, by a company, but does not include –
 - (i) any amount received from the Central Government or a State Government, or any amount received from any other source whose repayment is guaranteed by the Central Government or a State Government, or any amount received from a local authority, or any amount received from a statutory authority constituted under an Act of Parliament or a State Legislature ;
 - (ii) any amount received from foreign Governments, foreign or international banks, multilateral financial institutions (including, but not limited to, International Finance Corporation, Asian Development Bank, Commonwealth Development Corporation and International Bank for Industrial and Financial Reconstruction), foreign Governments owned development financial institutions, foreign export credit agencies, foreign collaborators, foreign bodies corporate and foreign citizens, foreign authorities or persons resident outside India subject to the provisions of Foreign Exchange Management Act, 1999 (42 of 1999) and rules and regulations made there under;
 - (iii) any amount received as a loan or facility from any banking company or from the State Bank of India or any of its subsidiary banks or from a

banking institution notified by the Central Government under section 51 of the Banking Regulation Act, 1949 (10 of 1949), or a corresponding new bank as defined in clause (d) of section 2 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) or in clause (b) of section (2) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980) , or from a co-operative bank as defined in clause (b-ii) of section 2 of the Reserve Bank of India Act, 1934 (2 of 1934) ;

- (iv) any amount received as a loan or financial assistance from Public Financial Institutions notified by the Central Government in this behalf in consultation with the Reserve Bank of India or any regional financial institutions or Insurance Companies or Scheduled Banks as defined in the Reserve Bank of India Act, 1934 (2 of 1934);
- (v) any amount received against issue of commercial paper or any other instruments issued in accordance with the guidelines or notification issued by the Reserve Bank of India;
- (vi) any amount received by a company from any other company;
- (vii) any amount received and held pursuant to an offer made in accordance with the provisions of the Act towards subscription to any securities, including share application money or advance towards allotment of securities pending allotment, so long as such amount is appropriated only against the amount due on allotment of the securities applied for;

Explanation.- For the purposes of this sub-clause, it is hereby clarified that –

- (a) Without prejudice to any other liability or action, if the securities for which application money or advance for such securities was received cannot be allotted within sixty days from the date of receipt of the application money or advance for such securities and such application money or advance is not refunded to the subscribers within fifteen days from the date of completion of sixty days, such amount shall be treated as a deposit under these rules.

“Provided that unless otherwise required under the Companies Act, 1956 (1 of 1956) or the Securities and Exchange Board of India Act, 1992 (15 of 1992) or rules or regulations made there

III.898 Auditing Pronouncements

under to allot any share, stock, bond, or debenture within a specified period, if a company had received any amount by way of subscriptions to any shares, stock, bonds or debentures before the 1st April, 2014 and disclosed it in the balance sheet for the financial year ending on or before the 31st March, 2014 against which the allotment is pending on the 31st March, 2015, the company shall, by the 1st June 2015, either return such amounts to the persons from whom these were received or allot shares, stock, bonds or debentures or comply with these rules."

- (b) any adjustment of the amount for any other purpose shall not be treated as refund.
- (viii) any amount received from a person who, at the time of the receipt of the amount, was a director of the company: or a relative of the director of the private company

Provided that the director of the company or relative of the director of the private company, as the case may be from whom money is received, furnished, to the company at the time of giving the money, a declaration in writing to the effect that the amount is not being given out of funds acquired by him by borrowing or accepting loans or deposits from others and the company shall disclose the details of money so accepted in the Board's Reports;

- (ix) any amount raised by the issue of bonds or debentures secured by a first charge or a charge ranking *pari passu* with the first charge on any assets referred to in Schedule III of the Act excluding intangible assets of the company or bonds or debentures compulsorily convertible into shares of the company within five years:

Provided that if such bonds or debentures are secured by the charge of any assets referred to in Schedule III of the Act, excluding intangible assets, the amount of such bonds or debentures shall not exceed the market value of such assets as assessed by a registered valuer;

- (x) any amount received from an employee of the company not exceeding his annual salary under a contract of employment with the company in the nature of non-interest bearing security deposit;
- (xi) any non-interest bearing amount received or held in trust;
- (xii) any amount received in the course of, or for the purposes of, the business of the company,

- (a) as an advance for the supply of goods or provision of services accounted for in any manner whatsoever provided that such advance is appropriated against supply of goods or provision of services within a period of three hundred and sixty five days from the date of acceptance of such advance:

Provided that in case of any advance which is subject matter of any legal proceedings before any court of law, the said time limit of three hundred and sixty five days shall not apply:

- (b) as advance, accounted for in any manner whatsoever, received in connection with consideration for an immovable property under an agreement or arrangement, provided that such advance is adjusted against such property in accordance with the terms of agreement or arrangement;
- (c) as security deposit for the performance of the contract for supply of goods or provision of services;
- (d) as advance received under long term projects for supply of capital goods except those covered under item (b) above:

Provided that if the amount received under items (a), (b) and (d) above becomes refundable (with or without interest) due to the reasons that the company accepting the money does not have necessary permission or approval, wherever required, to deal in the goods or properties or services for which the money is taken, then the amount received shall be deemed to be a deposit under these rules:

Explanation.- For the purposes of this sub-clause the amount referred to in the proviso shall be deemed to be deposits on the expiry of fifteen days from the date they become due for refund.

- (xiii) any amount brought in by the promoters of the company by way of unsecured loan in pursuance of the stipulation of any lending financial institution or a bank subject to fulfillment of the following conditions, namely:
 - (a) the loan is brought in pursuance of the stipulation imposed by the lending institutions on the promoters to contribute such finance;
 - (b) the loan is provided by the promoters themselves or by their relatives or by both; and

III.900 Auditing Pronouncements

- (c) the exemption under this sub-clause shall be available only till the loans of financial institution or bank are repaid and not thereafter;
- (xiv) any amount accepted by a Nidhi company in accordance with the rules made under section 406 of the Act.

Explanation.- For the purposes of this clause, any amount.

- (a) received by the company, whether in the form of instalments or otherwise, from a person with promise or offer to give returns, in cash or in kind, on completion of the period specified in the promise or offer, or earlier, accounted for in any manner whatsoever, or
- (b) any additional contributions, over and above the amount under item (a) above, made by the company as part of such promise or offer, shall be treated as a deposit;
- (d) “depositor” means,
 - (i) any member of the company who has made a deposit with the company in accordance with the provisions of subsection (2) of section 73 of the Act, or
 - (ii) any person who has made a deposit with a public company in accordance with the provisions of section 76 of the Act;
- (e) “eligible company” means a public company as referred to in sub-section (1) of section 76, having a net worth of not less than one hundred crore rupees or a turnover of not less than five hundred crore rupees and which has obtained the prior consent of the company in general meeting by means of a special resolution and also filed the said resolution with the Registrar of Companies before making any invitation to the Public for acceptance of deposits:

Provided that an eligible company, which is accepting deposits within the limits specified under clause (c) of subsection (1) of section 180, may accept deposits by means of an ordinary resolution;
- (f) “fees” means fees as specified in the Companies (Registration Offices and Fees) Rules, 2014;
- (g) “Form” or ‘e-Form” means a form set forth in Annexure to these rules which shall be used for the matter to which it relates;
- (h) “section” means section of the Act;

- (i) "trustee" means the trustee as defined in section 3 of the Indian Trusts Act, 1882 (12 of 1882).
- (2) Words and expressions used in these rules but not defined and defined in the Act or in the Reserve Bank of India Act, 1934 (2 of 1934) or in the Companies (Specification of definitions details) Rules, 2014, shall have the meanings respectively assigned to them in the said Acts or in the said rules.
- 3. Terms and conditions of acceptance of deposits by companies.-** (1) On and from the commencement of these rules,—
 - (a) no company referred to in sub-section (2) of section 73 and no eligible company shall accept or renew any deposit, whether secured or unsecured, which is repayable on demand or upon receiving a notice within a period of less than six months or more than thirty-six months from the date of acceptance or renewal of such deposit:

Provided that a company may, for the purpose of meeting any of its short-term requirements of funds, accept or renew such deposits for repayment earlier than six months from the date of deposit or renewal, as the case may be, subject to the condition that - (a) such deposits shall not exceed ten per cent of the aggregate of the paid up share capital, free reserves and securities premium account of the company, and
 - (b) such deposits are repayable not earlier than three months from the date of such deposits or renewal thereof.
- (2) Where depositors so desire, deposits may be accepted in joint names not exceeding three, with or without any of the clauses, namely, "Jointly", "Either or Survivor", "First named or Survivor", "Anyone or Survivor".
- (3) No company referred to in sub-section (2) of section 73 shall accept or renew any deposit from its members, if the amount of such deposits together with the amount of other deposits outstanding as on the date of acceptance or renewal of such deposits exceeds twenty five per cent. of the aggregate of the paid up share capital, free reserves and securities premium account of the company.
- (4) No eligible company shall accept or renew
 - (a) any deposit from its members, if the amount of such deposit together with the amount of deposits outstanding as on the date of acceptance or renewal of such deposits from members exceeds ten per cent of the aggregate of the

III.902 Auditing Pronouncements

paid up share capital, free reserves and securities premium account of the company;

- (b) any other deposit, if the amount of such deposit together with the amount of such other deposits, other than the deposit referred to in clause (a), outstanding on the date of acceptance or renewal exceeds twenty-five per cent. Of aggregate of the paid up share capital, free reserves and securities premium account of the company.
- (5) No Government company eligible to accept deposits under section 76 shall accept or renew any deposit, if the amount of such deposits together with the amount of other deposits outstanding as on the date of acceptance or renewal exceeds thirty five per cent of the aggregate of its paid up share capital, free reserves and securities premium account of the company.
- (6) No company referred to in sub-section (2) of section 73 or any eligible company shall invite or accept or renew any deposit in any form, carrying a rate of interest or pay brokerage thereon at a rate exceeding the maximum rate of interest or brokerage prescribed by the Reserve Bank of India for acceptance of deposits by non-banking financial companies.

Explanation:- For the purposes of this sub-rule, it is hereby clarified that the person who is authorised, in writing, by a company to solicit deposits on its behalf and through whom deposits are actually procured shall only be entitled to the brokerage and payment of brokerage to any other person for procuring deposits shall be deemed to be in violation of these rules.

- (7) The company shall not reserve to itself either directly or indirectly a right to alter, to the prejudice or disadvantage of the depositor, any of the terms and conditions of the deposit, deposit trust deed and deposit insurance contract after circular or circular in the form of advertisement is issued and deposits are accepted.
- (8) Every eligible company shall obtain, at least once in a year, credit rating for deposits accepted by it in the manner specified herein below and a copy of the rating shall be sent to the registrar of the companies along with the return of the deposits in form DPT-3.

Name of the agency	Minimum investment grade rating
(a) The credit rating information services of India Ltd.	FA- (FA Minus)
(b) ICRA Ltd.	MA- (MA Minus)

(c) Credit Analysis and Research Ltd.	CARE BBB(FD)
(d) Fitch Rating India Private Ltd.	tA(ind)(FD)
(e) Brickwork Rating India Private Ltd.	BWR FBBB]
(f) SME Rating Agency of India Ltd.	SMERAA

4. **Form and particulars of advertisements or circulars.-** (1) Every company referred to in sub-section (2) of section 73 intending to invite deposit from its members shall issue a circular to all its members by registered post with acknowledgement due or speed post or by electronic mode in Form DPT-1:

Provided that in addition to issue of such circular to all members in the manner specified above, the circular may be published in English language in an English newspaper and in vernacular language in a vernacular newspaper having wide circulation in the State in which the registered office of the company is situated.

- (2) Every eligible company intending to invite deposits shall issue a circular in the form of an advertisement in Form DPT-1 for the purpose in English language in an English newspaper and in vernacular language in one vernacular newspaper having wide circulation in the State in which the registered office of the company is situated.
- (3) Every company inviting deposits from the public shall upload a copy of the circular on its website, if any.
- (4) No company shall issue or allow any other person to issue or cause to be issued on its behalf, any circular or a circular in the form of advertisement inviting deposits, unless such circular or circular in the form of advertisement is issued on the authority and in the name of the Board of directors of the company.
- (5) No circular or a circular in the form of advertisement shall be issued by or on behalf of a company unless, not less than thirty days before the date of such issue, there has been delivered to the Registrar for registration a copy thereof signed by a majority of the directors of the company as constituted at the time the Board approved the circular or circular in the form of advertisement, or their agents, duly authorised by them in writing.
- (6) A circular or circular in the form of advertisement issued shall be valid until the expiry of six months from the date of closure of the financial year in which it is issued or until the date on which the financial statement is laid before the company in annual general meeting or, where the annual general meeting for any year has not been held, the latest day on which that meeting should have been held in

III.904 Auditing Pronouncements

accordance with the provisions of the Act, whichever is earlier, and a fresh circular or circular in the form of advertisement shall be issued, in each succeeding financial year, for inviting deposits during that financial year.

Explanation: For the purpose of this rule, the date of the issue of the newspaper in which the advertisement appears shall be taken as the date of issue of the advertisement and the effective date of issue of circular shall be the date of dispatch of the circular.

- 5. Manner and extent of deposit insurance.**- (1) Every company referred to in sub-section (2) of section 73 and every other eligible company inviting deposits shall enter into a contract for providing deposit insurance at least thirty days before the issue of circular or advertisement or at least thirty days before the date of renewal, as the case may be.

"Provided that the companies may accept deposit without deposit insurance contract till the 31st March, 2016 or till the availability of a deposit insurance product, whichever is earlier."

Explanation- For the purposes of this sub-rule, the amount as specified in the deposit insurance contract shall be deemed to be the amount in respect of both principal amount and interest due thereon.

- (2) The deposit insurance contract shall specifically provide that in case the company defaults in repayment of principal amount and interest thereon, the depositor shall be entitled to the repayment of principal amount of deposits and the interest thereon by the insurer up to the aggregate monetary ceiling as specified in the contract:

Provided that in the case of any deposit and interest not exceeding twenty thousand rupees, the deposit insurance contract shall provide for payment of the full amount of the deposit and interest and in the case of any deposit and the interest thereon in excess of twenty thousand rupees, the deposit insurance contract shall provide for payment of an amount not less than twenty thousand rupees for each depositor.

- (3) The amount of insurance premium paid on the insurance of such deposits shall be borne by the company itself and shall not be recovered from the depositors by deducting the same from the principal amount or interest payable thereon.
- (4) If any default is made by the company in complying with the terms and conditions of the deposit insurance contract which makes the insurance cover ineffective, the company shall either rectify the default immediately or enter into a fresh contract within thirty days and in case of non-compliance, the amount of deposits covered under the deposit insurance contract and interest payable thereon shall be repaid within the next fifteen days and if such a company does not repay the amount of

deposits within said fifteen days it shall pay fifteen per cent. interest per annum for the period of delay and shall be treated as having defaulted and shall be liable to be punished in accordance with the provisions of the Act.

- 6. Creation of security.**- (1) For the purposes of providing security, every company referred to in sub-section (2) of section 73 and every eligible company inviting secured deposits shall provide for security by way of a charge on its assets as referred to in Schedule III of the Act excluding intangible assets of the company for the due repayment of the amount of deposit and interest thereon for an amount which shall not be less than the amount remaining unsecured by the deposit insurance:

Provided that in the case of deposits which are secured by the charge on the assets referred to in Schedule III of the Act excluding intangible assets, the amount of such deposits and the interest payable thereon shall not exceed the market value of such assets as assessed by a registered valuer.

Explanation. I – For the purposes of this sub-rule it is clarified that the company shall ensure that the total value of the security either by way of deposit insurance or by way of charge or by both on company's assets shall not be less than the amount of deposits accepted and the interest payable thereon.

Explanation. II- For the purposes of proviso to sub-clause (ix) of clause (c) of sub-rule (1) of rule 2 and this sub-rule, it is hereby clarified that pending notification of sub-section (1) of section 247 of the Act and finalisation of qualifications and experience of valuers, valuation of stocks, shares, debentures, securities etc. shall be conducted by an independent merchant banker who is registered with the Securities and Exchange Board of India or an independent chartered accountant in practice having a minimum experience of ten years.

- (2) The security (not being in the nature of a pledge) for deposits as specified in sub-rule (1) shall be created in favour of a trustee for the depositors on:
- (a) specific movable property of the company, or
 - (b) specific immovable property of the company wherever situated, or any interest therein.

- 7. Appointment of trustee for depositors.**- (1) No company referred to in sub-section (2) of section 73 or any eligible company shall issue a circular or advertisement inviting secured deposits unless the company has appointed one or more trustees for depositors for creating security for the deposits:

III.906 Auditing Pronouncements

Provided that a written consent shall be obtained from the trustee for depositors before their appointment and a statement shall appear in the circular or circular in the form of advertisement with reasonable prominence to the effect that the trustees for depositors have given their consent to the company to be so appointed.

- (2) The company shall execute a deposit trust deed in Form DPT-2 at least seven days before issuing the circular or circular in the form of advertisement.
- (3) No person including a company that is in the business of providing trusteeship services shall be appointed as a trustee for the depositors, if the proposed trustee –
 - (a) is a director, key managerial personnel or any other officer or an employee of the company or of its holding, subsidiary or associate company or a depositor in the company;
 - (b) is indebted to the company, or its subsidiary or its holding or associate company or a subsidiary of such holding company;
 - (c) has any material pecuniary relationship with the company;
 - (d) has entered into any guarantee arrangement in respect of principal debts secured by the deposits or interest thereon;
 - (e) is related to any person specified in clause (a) above.
- (4) No trustee for depositors shall be removed from office after the issue of circular or advertisement and before the expiry of his term except with the consent of all the directors present at a meeting of the board.

Provided that in case the company is required to have independent directors, at least one independent director shall be present in such meeting of the Board

8. Duties of trustees. - It shall be the duty of every trustee for depositors to

- (a) ensure that the assets of the company on which charge is created together with the amount of deposit insurance are sufficient to cover the repayment of the principal amount of secured deposits outstanding and interest accrued thereon;
- (b) satisfy himself that the circular or advertisement inviting deposits does not contain any information which is inconsistent with the terms of the deposit scheme or with the trust deed and is in compliance with the rules and provisions of the Act;
- (c) ensure that the company does not commit any breach of covenants and provisions of the trust deed;

- (d) take such reasonable steps as may be necessary to procure a remedy for any breach of covenants of the trust deed or the terms of invitation of deposits;
 - (e) take steps to call a meeting of the holders of depositors as and when such meeting is required to be held;
 - (f) supervise the implementation of the conditions regarding creation of security for deposits and the terms of deposit insurance;
 - (g) do such acts as are necessary in the event the security becomes enforceable;
 - (h) carry out such acts as are necessary for the protection of the interest of depositors and to resolve their grievances.
- 9. Meeting of depositors.-** The trustee for depositors shall call a meeting of all the depositors on
- (a) requisition in writing signed by at least one-tenth of the depositors in value for the time being outstanding;
 - (b) the happening of any event, which constitutes a default or which, in the opinion of the trustee for depositors, affects the interest of the depositors.
- 10. Form of application for deposits.-** (1) On and from the commencement of these rules, no company shall accept, or renew any deposit, whether secured or unsecured, unless an application, in such form as specified by the company, is submitted by the intending depositor for the acceptance of such deposit.
- (2) The form of application referred to in sub-rule (1) shall contain a declaration by the intending depositor to the effect that the deposit is not being made out of any money borrowed by him from any other person.
- 11. Power to nominate.-** Every depositor may, at any time, nominate any person to whom his deposits shall vest in the event of his death and the provisions of section 72 shall, as far as may be, apply to the nomination made under this rule.
- 12. Furnishing of deposit receipts to depositors.-** (1) Every company shall, on the acceptance or renewal of a deposit, furnish to the depositor or his agent a receipt for the amount received by the company, within a period of twenty one days from the date of receipt of money or realisation of cheque or date of renewal.
- (2) The receipt referred to in sub-rule (1) shall be signed by an officer of the company duly authorised by the Board in this behalf and shall state the date of deposit, the

III.908 Auditing Pronouncements

name and address of the depositor, the amount received by the company as deposit, the rate of interest payable thereon and the date on which the deposit is repayable.

- 13. Maintenance of liquid assets and creation of deposit repayment reserve account.**- Every company referred to in sub-section (2) of section 73 and every eligible company shall on or before the 30th day of April of each year deposit the sum as specified in clause (c) of the said sub-section with any scheduled bank and the amount so deposited shall not be utilised for any purpose other than for the repayment of deposits:

Provided that the amount remaining deposited shall not at any time fall below fifteen per cent. of the amount of deposits maturing, until the end of the current financial year and the next financial year.

- 14. Registers of deposits.**- (1) Every company accepting deposits shall maintain at its registered office one or more separate registers for deposits accepted or renewed, in which there shall be entered separately in the case of each depositor the following particulars, namely:

- (a) name, address and PAN of the depositor/s;
- (b) particulars of guardian, in case of a minor;
- (c) particulars of the nominee;
- (d) deposit receipt number;
- (e) date and the amount of each deposit;
- (f) duration of the deposit and the date on which each deposit is repayable;
- (g) rate of interest or such deposits to be payable to the depositor;
- (h) due date for payment of interest;
- (i) mandate and instructions for payment of interest and for non-deduction of tax at source, if any;
- (j) date or dates on which the payment of interest shall be made;
- (k) details of deposit insurance including extent of deposit insurance;
- (l) particulars of security or charge created for repayment of deposits;
- (m) any other relevant particulars;

- (2) The entries specified in sub-rule (1) shall be made within seven days from the date of issuance of the receipt duly authenticated by a director or secretary of the company or by any other officer authorised by the Board for this purpose.
- (3) The register referred to in sub-rule (1) shall be preserved in good order for a period of not less than eight years from the financial year in which the latest entry is made in the register.

- 15. General provisions regarding premature repayment of deposits.-** Where a company makes a repayment of deposits, on the request of the depositor, after the expiry of a period of six months from the date of such deposit but before the expiry of the period for which such deposit was accepted, the rate of interest payable on such deposit shall be reduced by one per cent from the rate which the company would have paid had the deposit been accepted for the period for which such deposit had actually run and the company shall not pay interest at any rate higher than the rate so reduced :

Provided that nothing contained in this rule shall apply to the repayment of any deposit before the expiry of the period for which such deposit was accepted by the company, if such repayment is made solely for the purpose of—

- (a) complying with the provisions of rule 3; or
- (b) providing war risk or other related benefits to the personnel of the naval, military or air forces or to their families, on an application made by the associations or societies formed by such personnel, during the period of emergency declared under article 352 of the Constitution :

Provided further that where a company referred to in under sub-section (2) of section 73 or any eligible company permits a depositor to renew his deposit, before the expiry of the period for which such deposit was accepted by the company, for availing of a higher rate of interest, the company shall pay interest to such depositor at the higher rate if such deposit is renewed in accordance with the other provisions of these rules and for a period longer than the unexpired period of the deposit.

Explanation: For the purposes of this rule, where the period for which the deposit had run contains any part of a year, then, if such part is less than six months, it shall be excluded and if such part is six months or more, it shall be reckoned as one year.

- 16. Return of deposits to be filed with the Registrar.-** Every company to which these rules apply, shall on or before the 30th day of June, of every year, file with the Registrar, a return in Form DPT-3 along with the fee as provided in Companies (Registration Offices and Fees) Rules, 2014 and furnish the information contained

III.910 Auditing Pronouncements

therein as on the 31st day of March of that year duly audited by the auditor of the company.

17. **Penal rate of interest.**- Every company shall pay a penal rate of interest of eighteen per cent. per annum for the overdue period in case of deposits, whether secured or unsecured, matured and claimed but remaining unpaid.
18. **Power of Central Government to decide certain questions.** If any question arises as to the applicability of these rules to a particular company, such question shall be decided by the Central Government in consultation with the Reserve Bank of India.
19. **Applicability of sections 73 and 74 to eligible companies.**- Pursuant to provisions of sub-section (2) of section 76 of the Act, the provisions of sections 73 and 74 shall, mutatis mutandis, apply to acceptance of deposits from public by eligible companies.

Explanation.- For the purposes of this rule, it is hereby clarified that in case of a company which had accepted or invited public deposits under the relevant provisions of the Companies Act, 1956 and rules made under that Act (hereinafter known as "Earlier Deposits") and has been repaying such deposits and interest thereon in accordance with such provisions, the provisions of clause (b) of sub-section (1) of section 74 of the Act shall be deemed to have been complied with if the company complies with requirements under the Act and these rules and continues to repay such deposits and interest due thereon on due dates for the remaining period of such deposit in accordance with the terms and conditions and period of such Earlier Deposits and in compliance with the requirements under the Act and these rules;

Provided further that the fresh deposits by every eligible company shall have to be in accordance with the provisions of Chapter V of the Act and these rules;

20. **Statement regarding deposits existing as on the date of commencement of the Act.**- For the purposes of clause (a) of sub-section (1) of section 74, the statement shall be in Form DPT-4.
21. **Punishment for contravention.**- If any company referred to in sub-section (2) of section 73 or any eligible company inviting deposits or any other person contravenes any provision of these rules for which no punishment is provided in the Act, the company and every officer of the company who is in default shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first day during which the contravention continues.

Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 (Revised 2016)

OVERVIEW

I. Persons Covered for Reporting on Fraud under Section 143(12) of the Companies Act, 2013

Sub-section 12 of Section 143 of the Companies Act, 2013 (“the 2013 Act” or “the Act”), as amended, states, “Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

Provided that in case of fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board’s report in such manner as may be prescribed.”¹

The reporting requirement under Section 143(12) is for the statutory auditors of the company and also equally applies to the cost accountant in practice, conducting cost audit under Section 148 of the Act; and to the company secretary in practice, conducting secretarial audit under Section 204 of the Act.

However, **the provisions of Section 143(12) do not apply to other professionals who are rendering other services to the company.** For example, Section 143(12) does not apply to auditors appointed under other statutes for rendering other services such as tax auditor appointed for audit under Income-tax Act; Sales Tax or VAT auditors appointed for audit under the respective Sales Tax or VAT legislations.

It may also be noted that internal auditors covered under Section 138 are not specified as persons who are required to report under Section 143(12).

As per sub-rule (3) of Rule 12 of the Companies (Audit and Auditors) Rules, 2014, **the provisions of sub-section (12) of Section 143 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014 regarding reporting of frauds by the auditor shall also extend to a branch auditor appointed under Section 139 to the extent it relates to the concerned branch.**

It may be noted that **Section 143(12) includes only fraud by officers or employees of the company and does not include fraud by third parties such as vendors and customers.**

¹ The amendments to Section 143(12) have come into force on December 14, 2015.

III.912 Auditing Pronouncements

II. Thresholds and Manner of Reporting

The Companies (Audit and Auditors) Amendment Rules, 2015, issued by the Ministry of Corporate Affairs, on 14th December 2015, amended Rule 13 of the Companies (Audit and Auditors) Rules, 2014. The amended Rule 13 has introduced the thresholds for the purpose of reporting on frauds and a differential reporting responsibilities of the statutory auditor with respect to the fraud/s above or below the notified threshold.

As per the amended Rule 13, if an auditor of a company, in the course of performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of rupees one crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The amended Rule 13 provides the following manner of reporting to the Central Government:

- (a) the auditor shall report to the Board or the Audit Committee, as the case may be, immediately but not later than two days of his knowledge of the fraud, seeking their reply or observations within forty-five days;
- (b) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days from the date of receipt of such reply or observations;
- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
- (d) The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.
- (e) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- (f) The report shall be in the form of a statement as specified in Form **ADT-4**.

In case of a fraud involving lesser than rupees one crore, the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and he shall report the matter specifying the following:-

- a) Nature of Fraud with description;
- b) Approximate amount involved; and
- c) Parties involved.

The following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) of amended Rule 13 during the year shall be disclosed in the Board's Report:-

- a) Nature of Fraud with description;
- b) Approximate Amount involved;
- c) Parties involved, if remedial action not taken; and
- d) Remedial action taken.

III. Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements

Section 143(12) requires an auditor to report on fraud if ***in the course of performance of his duties as an auditor***, the auditor has reason to believe that an offence of fraud is being or has been committed in the company by its officers or employees.

It may be noted that under section 143(9) read with Section 143(10), the duty of the auditor, *inter alia*, in an audit is to comply with the Standards on Auditing (SAs). Further, Section 143(2) requires the auditor to make out his report after taking into account, *inter alia*, the auditing standards. Accordingly, the term, "in the course of performance of his duties as an auditor" implies in the course of performing an audit as per the SAs.

The definition of fraud as per SA 240 and the explanation of fraud as per Section 447 of the 2013 Act are similar, except that ***under Section 447, fraud includes 'acts with an intent to injure the interests of the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.'***

However, an auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account/financial statements of the company. For example,

- an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;
- if the password of a key managerial personnel is stolen and misused to access confidential/restricted information, the effect of the same may not be determinable by the management or by the auditor;
- if an employee is alleged to be carrying on business parallel to the company's business and has been diverting customer orders to his company, the auditor may not be able to detect the same since such sales transactions are not recorded in the books of the company.

Therefore, ***the auditor shall consider the requirements of the SAs, insofar as it relates to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.***

IV. Reporting on Suspected Offence Involving Frauds Identified/Noted during Audit/Limited Review of Interim period Financial Statements/Results, Other Attest Services and Permitted Non-attest Services

III.914 Auditing Pronouncements

Section 143 of the 2013 Act was notified and is effective from April 1, 2014. Whilst Section 143 deals with auditor's duties and responsibilities under the Act with respect to financial statements prepared under the Act, the auditors perform other attest services in their capacity as auditors of the company. For example, (a) Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements), Regulations 2015 requires the statutory auditor to perform limited review/audit of the quarterly financial results published by the listed companies; (b) the auditor may also be engaged by the Board of directors of the company to carry out the audit of interim financial statements prepared by the management as per Accounting Standard 25 and report on such interim financial statements to the Board of Directors; (c) the auditor may also perform tax audit under the Income-tax Act, 1961; or (d) the auditor may be engaged to issue certificates, etc.

In the case of the aforesaid attest services for financial years beginning on or after 1st April, 2014, the following needs to be considered:

- (a) Such attest services may not be pursuant to any requirement of the 2013 Act. They may rather be rendered to meet the specific requirements of the company (such as complying with the Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements), Regulations 2015, to meet the requirements of the Board of Directors of the company, etc.).
- (b) Wherever a statute or regulation requires such attest services to be performed by the auditor of the company, the auditor should consider the requirements and provisions of Section 143(12) since any such work carried out by the auditor during such attest services could be construed as being in the course of performing his duties as an auditor, albeit not under the Companies Act, 2013.
- (c) The objective and scope of such attest services and the procedures performed by the auditor may not be of the same extent and level as in the case of the audit of the financial statements prepared under the 2013 Act. For example, the quarterly results under Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements), Regulations 2015 may be subject to a limited review performed in accordance with the Standards on Review Engagements and hence would not have been performed in accordance with the SAs.

Auditors could be engaged to provide non-attest services that are not prohibited under Section 144 of the Act. It is possible that the auditor, when providing such non-attest services may become aware of a fraud that is being or has been committed in the company by its officers or employees.

A question that arises is – should the auditor report under Section 143(12) on frauds noted in the course of providing such other attest or non-attest services?

If an offence of fraud in the company by its officers or employees that is identified/noted by the auditor in the course of providing such attest or non-attest services as referred above, is of such amount/s as specified in Rule 13 of the Companies (Audit and Auditors) Rules, 2014 {as amended by the Companies (Audit and Auditors) Amendment Rules, 2015} which the auditor uses or intends to use the information that is obtained in the course of performing such attest or non-attest services when performing the audit under the 2013 Act,

then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder, as specified in this Guidance Note.

V. Reporting on Frauds Detected by the Management or Other Persons and already Reported under Section 143(12) by Such Other Person

Paragraph 4 of SA 240 states and clarifies that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In the context of the 2013 Act, this position is reiterated in Section 134(5) which states that the Board report shall include a responsibility statement, *inter alia*, that the directors had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities. ***Based on the above, it may be considered that Section 143(12) envisages the auditor to report to the Audit Committee under section 177 of the Companies Act, 2013 or to the Board of Directors and thereafter, where applicable, to the Central Government an offence of fraud in the company by its officers or employees only if he is the first person to identify/note such instance in the course of performance of his duties as an auditor.***

Accordingly, in case a fraud has already been reported or has been identified/detected by the management or through the company's vigil/whistle blower mechanism and has been/is being remediated/dealt with by them and such case is informed to the auditor, he will not be required to report the same under Section 143(12) since he has not per se identified the fraud.

The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

Since reporting on fraud under Section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, ***if a suspected offence of fraud has already been reported under Section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same to the Audit Committee under section 177 of the Companies Act 2013 or the Board of Directors and thereafter, where applicable, to the Central Government under the section since he has not per se identified the suspected offence of fraud.***

However, in case of a fraud which involves or is expected to involve individually, an amount of rupees one crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence of fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed. If the management/those charged with governance fail to undertake appropriate additional

procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Amendment Rules, 2015.

VI. Reporting on Suspected Offence Involving Fraud in case of Consolidated Financial Statements

As per Section 129(4) of the 2013 Act, the provisions relating to audit of the standalone financial statements of the holding company shall also apply to the audit of the consolidated financial statements. Since the audit of the consolidated financial statements has also been made one of the duties of the auditor, a question that arises is – should the auditor report on suspected offence involving frauds that may have taken place in any of the subsidiaries, joint ventures, associates of the company?

Reporting under Section 143(12) arises only if a suspected offence of fraud is being or has been committed in the company by its officers or employees.

Accordingly, the auditor of the parent company is not required to report on frauds under Section 143(12) if they are not being or have not been committed in the parent company by the officers or employees of the parent company but relate to frauds in:

- a) ***A component that is an Indian company, since the auditor of that Indian company is required to report on suspected offence involving frauds under Section 143 (12) in respect of such company; and***
- b) ***A foreign corporate component or a component that is not a company since the component auditors' of such components are not covered under Section 143(12).***

However, the auditor of the parent company in India will be required to report on suspected offence involving frauds in the components of the parent company, if the suspected offence of fraud in the component is being or has been committed by employees or officers of the parent company and if such suspected offence involving fraud in the component is against the parent company, if:

- a) ***the principal auditor identifies/detects such suspected offence involving fraud in the component "in the course of the performance of his duties as an auditor" of the consolidated financial statements; or***
- b) ***the principal auditor is directly informed of such a suspected offence involving fraud in the component by the component auditor and the management had not identified/is not aware of such suspected offence involving fraud in the component; or***
- c) ***a component that is not a company since the component auditors of such components are not covered under Section 143(12).***

VII. Reporting under Section 143(12) when the Suspected Offence Involving Fraud relates to periods prior to coming into effect of the 2013 Act

Requirements similar to Section 143(12) of the 2013 Act were not prescribed in the 1956 Act. Even the reporting under the Companies (Auditor's Report) Order, 2003 (CARO) only required the auditors to report to the members on any fraud on or by the company that had been noticed or reported during the year.

As such, auditors would not have reported on frauds as envisaged under Section 143(12) in those periods prior to coming into effect of the 2013 Act. Accordingly, ***in case of fraud relating to earlier years to which the Companies Act, 1956 was applicable, reporting under Section 143(12) will arise only if the suspected offence of fraud is identified by the auditor in the course of performance of his duties as an auditor during the financial years beginning on or after April 1, 2014 and to the extent that the same was not dealt with in the prior financial years either in the financial statements or in the audit report or in the Board's report under the Companies Act, 1956.***

VIII. When does an Auditor Commence Reporting under Section 143(12) – Based on Suspicion - Reason to Believe – Knowledge – or on Determination of Offence?

Section 143(12) states that an auditor should report under the Section if he has "reason to believe" that an offence of fraud has or is being committed in the company by its officers or employees. Rule 13 of the Companies (Audit and Auditors) Amendment Rules, 2015 specifies the threshold for reporting as "reason to believe" and "knowledge". The Form ADT – 4 in which the auditor is required to report to the Central Government uses the term "suspected offence involving fraud".

It is important to understand the terms "reason to believe", "knowledge" and "suspected offence involving fraud" to determine the point of time when the reporting requirement is triggered for an auditor under Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Amendment Rules, 2015.

- 'Suspicion' is a state of mind more definite than speculation, but falls short of knowledge based on evidence. It must be based on some evidence, even if that evidence is tentative – simple speculation that a person may be engaged in fraud is not sufficient grounds to form a suspicion. Suspicion is a slight opinion but without sufficient evidence.
- For 'reason to believe' to come into existence, it cannot be based on suspicion. There needs to be sufficient information or convincing evidence to advance beyond suspicion that it is possible someone is committing or has committed a fraud. For example, identification of fraud risk factors in itself cannot cause 'reason to believe' that a fraud exists.
- The term 'reason to believe' creates an objective test. SA 240, "The Auditor's Responsibilities Relating to Frauds in an Audit of Financial Statements" specifies the requirements to be complied by the auditors in assessing and responding to the risk of fraud in an audit of financial statements. For example, when complying with the requirements of SA 240, an auditor might be considered to have reasons to believe that a fraud has been or is being committed if he had actual knowledge of, or possessed information which would indicate to a reasonable person, that another person was committing or had committed a fraud.

III.918 Auditing Pronouncements

- The term 'reason to believe' which has been used in the SAs indicate that it arises when:
 - Evaluating audit evidence and information provided; or
 - Evaluating misstatements, including deviations noted on audit sampling and further audit procedures carried out; or
 - Exercising professional skepticism.
- **Rule 13 of the Companies (Audit and Auditors) Amendment Rules, 2015 has used the terms 'reason to believe' and 'knowledge' (of fraud). The condition of 'reason to believe' would be met if on evaluation of all the available information with the auditor and applying appropriate level of skepticism the auditor concludes that a fraud is being or has been committed on the company.**
- **Having 'knowledge' means knowing 'that' something. In the case of reporting on fraud under Section 143(12), it occurs when the auditor has sufficient reason to believe that a fraud has been or is being committed on the company by its officers or employees. This implies that there exists a fraud.**
- Whilst Section 143(12) uses the term 'offence of fraud' and the Form ADT – 4 uses the term "suspected offence involving fraud". **As per paragraph 3 of SA 240, although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determination of whether fraud has actually occurred.** Determination of "offence" is legal determination and accordingly, the auditor will not be able to legally determine that an "offence or suspected offence involving fraud" has been or is being committed against the company by its officers or employees.

Accordingly, **based on a harmonious reading of Section 143(12), Rule 13 of the Companies (Audit and Auditors) Amendment Rules, 2015 and Form ADT - 4, reporting on fraud in the course of performance of duties as auditor, is applicable only when the auditor has reason to believe and has knowledge that a fraud has occurred or is occurring i.e., when the auditor has evidence that a fraud exists.**

IX. Can the Auditor apply the Concept of Materiality for Reporting on Fraud?

The concept of materiality is fundamental for setting up an appropriate system of internal control, preparation of financial statements and its audit. Due to its inherent limitations, internal control systems cannot provide absolute assurance that no fraud or error has taken place. Since the auditor is required to comply with the SAs in performance of duties as an auditor, the audit will be performed applying the concept of materiality provided in the SAs.

Section 143(9) requires the auditor to comply with the SAs, which, *inter alia*, includes consideration of materiality, applying materiality in evaluating misstatements and disposition of the same.

The auditor should continue to apply the concept of materiality in performing the audit in accordance with SA 320 "Materiality in Planning and Performing an Audit".

Fraud results in misstatement of financial statements. The SAs outline the procedures to be performed by an auditor in case a misstatement due to fraud is identified by the auditor. For example, paragraph A52 of SA 240 states that in evaluating and disposing the misstatements

identified, the auditor should consider the requirements of SA 450 "Evaluation of Misstatements Identified during the Audit".

SA 450 considers the concept of materiality in classifying the manner of disposition of misstatements, including those arising from fraud. Misstatements arising from fraud, will need to be communicated to the management and/or those charged with governance as required under paragraphs A21 to A23 of SA 450 and also reported to the Central Government in accordance with the requirements specified in Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended, in case the amount involved or expected to involve is individually Rupees One Crore or more.

Materiality is applicable wherever the amount is quantifiable. Where the amount is not quantifiable, the auditor should apply professional judgement to estimate the likelihood of the amount exceeding the aforesaid limit of Rupees One Crore prescribed for reporting to the Central Government. For this purpose it can be based on management estimate or reasonable range of estimate made by the auditor. Subsequent reporting may be required if the amount initially estimated was lower than the aforesaid limit but was eventually determined to be higher than such limit. Under these circumstances, the timeline for reporting under Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, will commence when the amount involved is determined to be in excess of such limit.

X. Should the Auditor Report under Section 143(12) in case of Corruption, Bribery, Money Laundering and Non-compliance with other Laws and Regulations

In case of corruption, bribery and money laundering, the direct effect of such act (benefit or penal consequence) is on the company.

The auditor should comply with the relevant SAs with regard to illegal acts (e.g. SA 240 and SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements") when performing the audit. If the auditor, in the course of performance of his/her duties as the auditor, comes across instances of corruption, bribery and money laundering and other intentional non-compliances with laws and regulations, the auditor would need to evaluate the impact of the same in accordance with SA 250 to determine whether the same would have a material effect on the financial statements.

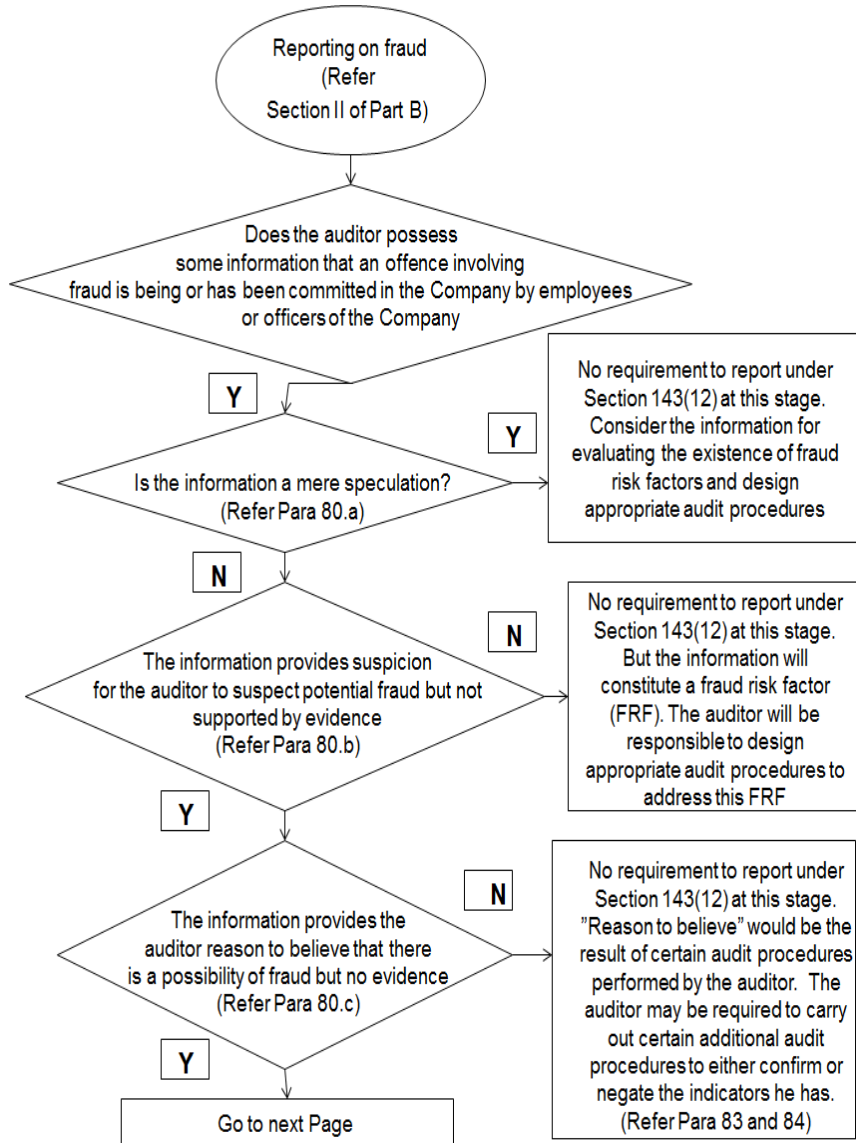
With respect to reporting under Section 143(12), consequent to corruption, bribery, money laundering and other intentional non-compliance with other laws and regulations, the auditor should consider whether such acts have been carried out by officers or employees of the company for the purpose of reporting and also take into account the requirements of SA 250, particularly paragraph 28 of SA 250 read with paragraphs A19 and A20.

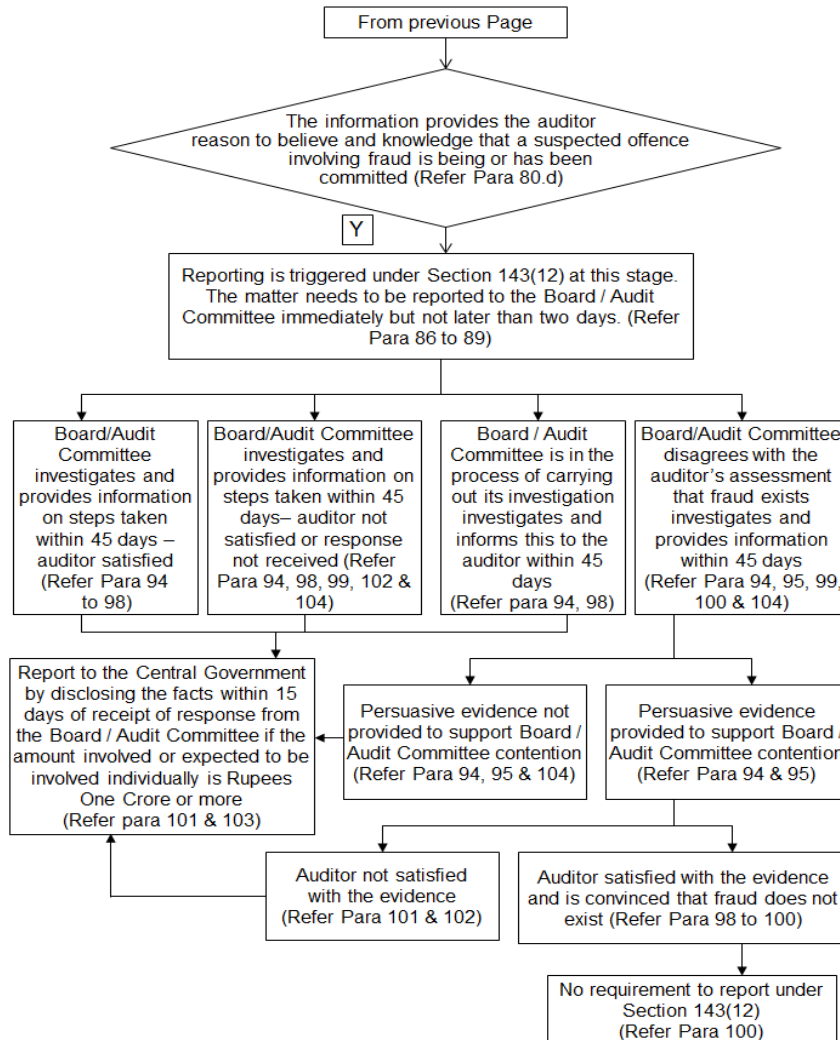
For example, if the auditor comes to know that the company has filed a fraudulent return of income to evade income tax, he may have to report this fraud under Section 143(12) irrespective of whether adequate provision has been made in the books of accounts or not.

It may be noted that the proviso to Section 147(2) in the context of punishment to auditors for contravention with the provisions, inter alia, of Section 143 of the 2013 Act, states, "if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with

imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.”

XI. Reporting on Fraud under Section 143(12) – Decision Tree/Flow Chart





SECTION I: INTRODUCTION

1. Fraud has the capacity to undermine the confidence of stakeholders in an organisation and there is a strong nexus between prevention of fraud and good corporate governance.
2. Consideration of fraud in financial reporting and the auditor's responsibility on reporting on fraud has always been an integral part of an audit of financial statements carried out in accordance with the Standards on Auditing. Misstatements in the financial statements can arise from either fraud or error and the distinguishing factor between the two is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. **The auditor is**

required to consider fraud as a risk that could cause a material misstatement in the financial statements and plan and perform such procedures that mitigate the risk of material misstatement due to fraud. These requirements are specified in Standard on Auditing (SA) 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

Requirements for Reporting on Fraud under the Companies Act, 2013

3. Section 143(12) of the Companies Act, 2013 ('the 2013 Act' or 'the Act'), as amended, states that "Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

Provided that in case of fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed."²

Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015 specifies the manner in which the auditor is required to report on fraud to the Central Government and Form ADT 4 to these Rules (Refer **Appendix 6**) provides the format and information to be included in such report.

4. ***In terms of provisions of Section 143(14) of the 2013 Act, the reporting requirement under Section 143(12) is for auditors of the company and also equally applies to the cost accountant in practice conducting cost audit under Section 148 of the Act; as well as the company secretary in practice conducting secretarial audit under Section 204 of the Act. However, the provisions of Section 143(12) do not apply to other professionals who are rendering other services to the company. Further, Section 143(12) also does not apply to auditors appointed under other statutes for rendering services such as Tax Audit under the Income-tax Act, 1961; Sales Tax audit or VAT audit.***

It may be noted that internal auditors covered under Section 138 are not specified as persons who are required to report under Section 143(12.)

5. ***Section 143(12) includes only fraud by officers or employees of the company and does not include fraud by third parties such as vendors and customers.***

Suspected fraud by vendors, customers and other third parties should be dealt with in accordance with SA 240.

² The amendments to Section 143(12) have come into force on December 14, 2015.

Section 2(59) of the 2013 Act, defines the term “officer” to include any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act.

The 2013 Act does not define the term “employees”. However, in common parlance, the term “employees” implies those persons who are on the payroll of the company. **Employees would, therefore, not include those persons who are engaged on a contract basis e.g. security, house-keeping, canteen staff, who work in the company premises on behalf of a contractor who has been given the contract to provide such services to the company. In this instance, the contract workers will be considered as vendors and not employees.**

6. This Guidance Note aims to provide guidance to the auditors on matters that may arise pursuant to the reporting requirements on fraud under Section 143(12) of the Act. Section 143(12) specifically states that the auditor should report to the Audit Committee under section 177 of the Companies Act, 2013 or the Board of Directors and, where applicable, to the Central Government if he has reason to believe that an offence of fraud is being or has been committed in the company by its officers or employees if the auditor has noted it “in the course of the performance of his duties as auditor”. Accordingly, the Guidance Note should be read in conjunction with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) since Section 143(9) of the 2013 Act read with Section 143(10) casts a duty and responsibility on the auditor to comply with the SAs.

7. Reporting by the auditor on fraud is not a new concept in India. Such reporting exists under the SAs, the Companies Act, 1956, RBI Regulations, etc. The guidance provided by the ICAI in these contexts continues to be relevant and applicable even in the case of reporting by the auditor on fraud under Section 143(12) of the 2013 Act.

8. **The requirements for reporting by auditors under Section 143(12) would apply even if the fraud is required to be/has been reported under any other statute or to any other Regulator.** For example, in case of a fraud identified in a Bank, the auditor of the Bank should report the fraud to the RBI as per the requirements of the RBI Regulations on audit of Banks (Refer paragraph 11 below). If the Bank is a company and is governed by the provisions of the 2013 Act, in addition to the reporting to the RBI, the auditor may also be required to report the offence involving fraud to the Central Government if such instance is covered under Section 143(12) of the 2013 Act, as specified in this Guidance Note.

9. Consideration of Fraud in an Audit of Financial Statements as required by Standards on Auditing

Various SAs state the requirements for the auditor to consider the risk of fraud in an audit of financial statements and the manner of dealing with the same:

a. SA 240, *inter alia*, states the following:

Paragraph 5 - ‘An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free

III.924 Auditing Pronouncements

from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.'

Paragraph 40 - 'If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities'.

Paragraph 43 - 'If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances'.

Paragraph A66 - 'In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation'.

- b. Paragraphs 22 and 23 of SA 250 – "Consideration of Laws and Regulations in an Audit of Financial Statements", requires the auditor, *inter alia*, to communicate to those charged with governance (the Audit Committee/Board of Directors) when there is a non – compliance with laws and regulations, that come to the auditor's attention during the course of the audit, which he/she believes is intentional and material, without delay.
- c. Paragraph 27 of SA 315 – "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", requires the auditor to consider the risk of fraud in determining which risks are significant risks.

10. Reporting on Fraud under Section 227 (4A) of the Companies Act, 1956 as per the Companies (Auditor's Report) Order, 2003 ('CARO')

(Note: The following guidance is included here only to briefly explain the erstwhile reporting requirements of the statutory auditor relating to fraud for a better understanding of and comparison with the current reporting requirements).

Clause 4 (xxi) of CARO required the auditor to report whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated. The Statement on the Companies (Auditor's Report) Order, 2003 ('the Statement') issued by the ICAI specified the responsibilities of the auditor when reporting under clause 4(xxi) of CARO. As per the Statement:

- a. Clause 4(xxi) does not require the auditor to discover the frauds on the company and by the company. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds on the company or by the company that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report

whether any fraud on or by the company has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements".

- b. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the "management fraud" can be construed as "fraud by the company" while fraud committed by the employees or third parties may be termed as "fraud on the company".
- c. Two types of intentional misstatements are relevant to the auditor's consideration of fraud—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
- d. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:
 - Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
 - Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
 - Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
- e. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.
- f. Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management

* Now known as SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

- g. While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.
- h. The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire of the management about any frauds on or by the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees of the company. The auditor should also examine the minutes book of the Board meeting of the company in this regard.
- i. The auditor should obtain written representations from the management, stating, *inter alia*, (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error; (ii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and (iii) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- j. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate.

11. Reporting to RBI in case of Fraud noted in Audit of Banks

The RBI issued Circular No. DBS.FGV.(F).No. BC/23.08.001/2001-02 dated May 3, 2002 relating to implementation of recommendations of the Committee on Legal Aspects of Bank Frauds (Mitra Committee) and the recommendations of the High Level Group set-up by the Central Vigilance Commission applicable to all scheduled commercial banks (excluding RRBs). Regarding responsibility and liability of accounting and auditing professionals, the said Circular provides as under:

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess

power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

Paragraphs 2.32 to 2.38 of Chapter 2 of Part I of the Guidance Note on Audit of Banks 2016 edition provides guidance to the auditors with respect to fraud noted in an audit of Banks and, *inter alia*, states as follows.

- a. As per the above requirement, the member shall be required to report the kind of matters stated in the circular to the regulator, i.e., RBI. In this regard, attention of the members is also invited to Clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that “A chartered accountant in practice shall be deemed guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force.”
- b. Under the said provision, if a member of the Institute *suo moto* discloses any information regarding any actual or possible fraud or foul play to the RBI, the member would be liable for disciplinary action by the Institute. However, a member is not held guilty under the said clause if the client explicitly permits the auditor to disclose the information to a third party. If the above-mentioned requirement of the Circular is included in the letter of appointment (which constitutes the terms of audit engagement) then it would amount to the explicit permission by the concerned bank (client) to disclose information to the third party, i.e., the RBI.
- c. Thus, auditors while reporting such a matter to the Bank should also report the matter simultaneously to the Department of Banking Supervision, RBI, provided the terms of the audit engagement require him to do so.
- d. Auditor should also consider the provisions of SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”. Para A19 of the said Standard explains that the duty of confidentiality may be over-ridden by statute, law or by courts (for example, the auditor is required to report certain matters of non-compliance to RBI as per the requirements of the Non-Banking Financial Companies Auditor’s Report (Reserve Bank) Directions, 1988, issued by the RBI).
- e. RBI has issued a Master Circular no. DBS.CO.CFMC.BC.No. 1/23.04.001/2015-16 dated July 1, 2015 on “Frauds–Classification and Reporting” on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As per the said circular, the primary responsibility for preventing frauds is that of the Bank management. Banks are required to report frauds to the Board of Directors and also to the RBI.
- f. In the aforesaid context, it may be emphasised that such a requirement does not extend the responsibilities of an auditor in any manner whatsoever as far as conducting the audit is concerned. The requirement has only extended the reporting responsibilities of the

auditor. As far as conduct of audit is concerned, the auditor is expected to follow the Standards on Auditing issued by the ICAI and perform his functions within that framework. SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

- g. The auditor should also refer to reports of internal auditors, concurrent auditors, inspectors, etc., which may point out significant weaknesses in the internal control system. Such an evaluation would also provide the auditor about the likelihood of occurrence of transactions involving exercise of powers much beyond those entrusted to an official. It must be noted that the auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to the Chairman/Managing Director/Chief Executive of the concerned Bank.

Responsibility of Management

12. It may be noted that the primary responsibility to establish adequate internal control systems to prevent and detect frauds and errors is that of the management of the entity. In the case of a company, the Board of Directors, in terms of the provisions of Section 134(5) of the 2013 Act, are required to, *inter alia*, state as a part of the directors' responsibility statement in the Board report to the shareholders, that they had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

In the case of a listed company, clause (e) of Sub-section 5 of Section 134 to the Act requires the directors' responsibility statement to also state that the directors, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively. This clause explains the meaning of internal financial controls as "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

13. Audit Committee's Responsibility on Vigil Mechanism

Sections 177(9) and (10) of the 2013 Act requires every listed company and the specified class or classes of companies³, to establish a vigil mechanism for directors and employees to report

³ As per Rule 7(1) of the Companies (Meetings of Board and Its Powers) Rules, 2014, the following classes of companies are also required to establish a vigil mechanism:

- (i) companies which accept deposits from the public.
- (ii) companies which have borrowed money from banks and public financial institutions in excess of Rs. 50 crores.

genuine concerns in the manner as prescribed under the Companies (Meetings of Board and its Powers) Rules, 2014. The vigil mechanism needs to provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. The details of establishment of such mechanism are required to be disclosed by the company on its website, if any, and in the Board's report.

14. Code of Conduct for Independent Directors

Section 149(8) of the 2013 Act deals with appointment and qualification of directors and prescribes the code of conduct for independent directors (Schedule IV to the Act). The Code provides a broad framework for, among other things, role and responsibilities of the independent directors, including:

- a. paying sufficient attention and ensuring that adequate deliberations are held before approving related party transactions and assure themselves that the same are in the interest of the company;
- b. ascertaining and ensuring that the company has an adequate and functional vigil mechanism and to ensure that the interests of a person who uses such mechanism are not prejudicially affected on account of such use;
- c. reporting concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy;
- d. satisfying themselves on the integrity of the financial information and that the financial controls and the systems of risk management are robust and defensible;
- e. safeguarding the interests of all the stakeholders, particularly, the minority shareholders;
- f. ensuring that their concern about the running of the company or a proposed action are addressed by the Board and to the extent they are not resolved, insist that their concerns are recorded in the minutes of the meeting of the Board

Various Definitions of Fraud

15. In the 2013 Act, the meaning of fraud has been considered in two specific sections *viz.* Section 143(10), where the SAs specified by the ICAI are deemed to be the auditing standards for purposes of the Act, which, *inter alia*, define fraud, and in Section 447, where punishment for fraud has been prescribed.

- a. Fraud has been defined in paragraph 11(a) of SA 240 as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.'
- b. ***In the context of stating the provisions for punishment for fraud, Section 447 of the Act has explained the term 'fraud'*** as "fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of fact or abuse of position committed by any person or any other person with the connivance in any manner, with

III.930 Auditing Pronouncements

intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.”

This Section further explains the terms ‘wrongful gain’ and ‘wrongful loss’ to mean the gain by unlawful means of property to which the person gaining is not legally entitled; and the loss by unlawful means of property to which the person losing is legally entitled, respectively.

16. Fraud has also been defined by various other regulators/statutes.
- a. The Insurance Fraud Monitoring Framework of the IRDA defines fraud in insurance as ‘an act or omission intended to gain dishonest or unlawful advantage for a party committing the fraud or for other related parties.’
 - b. Reserve Bank of India, *per se*, has not defined the term ‘fraud’ in its guidelines on Frauds. A definition of fraud was, however, suggested in the context of electronic banking in the Report of RBI Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds, which reads as, ‘a deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank’.
 - c. Fraud, under Section 17 of the Indian Contract Act, 1872, includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:
 - the suggestion as a fact, of that which is not true, by one who does not believe it to be true;
 - the active concealment of a fact by one having knowledge or belief of the fact;
 - a promise made without any intention of performing it;
 - any other act fitted to deceive;
 - any such act or omission as the law specially declares to be fraudulent.

SECTION II: AUDITORS' REPORTING ON FRAUD UNDER SECTION 143(12)

17. Sections 143(12) to 143(15) of the 2013 Act states the provisions of the 2013 Act with regard to auditor's reporting on fraud. Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, provides the timeline and manner in which the auditor should report on fraud.

18. As per Section 143(12), **Notwithstanding anything contained in this section**, if an auditor of a company, **in the course of the performance of his duties as auditor**, has **reason to believe that an offence of fraud** involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed. *(emphasis added)*

Provided that in case of fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed."

19. As per Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015:

- (1) If an auditor of a company, in the course of the performance of his duties as **statutory auditor, has reason to believe** that an **offence of fraud**, which involves or is expected to involve individually an amount of Rupees One Crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government. *(emphasis added)*
- (2) The auditor shall report the matter to the Central Government as under:-
 - (a) the auditor shall report to the Board or the Audit Committee, as the case may be, immediately but not later than two days of his knowledge of the fraud, seeking their reply or observations within forty-five days;
 - (b) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days from the date of receipt of such reply or observations;
 - (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
 - (d) The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover

III.932 Auditing Pronouncements

by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.

- (e) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
 - (f) The report shall be in the form of a statement as specified in Form **ADT-4**.
- (3) In case of a fraud involving lesser than the amount specified in sub-rule (1), the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and he shall report the matter specifying the following:-
- (a) Nature of Fraud with description;
 - (b) Approximate amount involved; and
 - (c) Parties involved.
- (4) The following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year shall be disclosed in the Board's Report:-
- (a) Nature of Fraud with description;
 - (b) Approximate Amount involved;
 - (c) Parties involved, if remedial action not taken; and
 - (d) Remedial action taken.

20. Section 143(13) states that 'No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in Sub-section (12) if it is done in good faith'.

Accordingly, the auditor will not be subject to professional misconduct if he discloses information acquired in the course of his professional engagement with respect to compliance with Section 143(12), since it is as required by law.

21. Further, Section 456 of the Act also, *inter alia*, provides that no suit, prosecution or other legal proceeding shall lie against any person in respect of anything which is in good faith done or intended to be done in pursuance of this Act or of any rules or orders made thereunder.

22. As per Section 143(15), if any auditor does not comply with the provisions of Sub-section 143(12), he shall be punishable with fine of at least one lakh rupees, which may extend to twenty-five lakh rupees.

23. As per Sub-rule (3) of Rule 12 of the Companies (Audit and Auditors) Rules, 2014, ***the provisions of Sub-section (12) of Section 143 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014 regarding reporting of fraud by the auditor also extend to a branch auditor appointed under Section 139 to the extent it relates to the concerned branch.***

24. **While the reporting responsibility under Section 143(12) is to the Audit Committee or the Board of Directors of the Company and / or to the Central Government, the auditor would also need to consider whether such matter also needs to be disclosed in the auditor's report under Section 143(3)(f) which requires the auditor to state his/her observations on financial transactions/matters, which have any adverse effect on the functioning of the company.**

25. It is pertinent to note that the auditor is also required to report on fraud in terms of paragraph 3 (xii) of the Companies (Auditors Report) Order, 2015 on all frauds during the year whether noticed or reported by the auditor or the Company or by any others, even if reporting as required under Section 143(12) has been made by the auditor.

Issues for Consideration by Auditors for Reporting under Section 143(12)

Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements

26. Paragraph 10 of SA 240 states that the objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to identified or suspected fraud.

27. Paragraph 4 of SA 240 also states and clarifies that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

28. In the context of the 2013 Act, this position is reiterated in Section 134(5) which states that the Board report shall include a responsibility statement, *inter alia*, that the directors had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

29. Section 143(9) read with Section 143(10), requires the auditor to comply with the SAs issued by ICAI. Further, Section 143(2) requires the auditor to make out his report after taking into account, *inter alia*, the auditing standards. Accordingly, the term "in the course of performance of his duties as an auditor" may be understood to mean in the course of performing an audit in accordance with the SAs.

30. Based on the above, it is reasonable to conclude that the objective of an auditor in the course of performance of duties as an auditor in accordance with the SAs, is to perform such

III.934 Auditing Pronouncements

procedures that provide sufficient appropriate audit evidence about the risks of material misstatement in the financial statements due to fraud that have been assessed by him through designing and implementing appropriate responses, and to respond appropriately to identified or suspected fraud.

31. The definition of fraud as per SA 240 and the explanation of fraud as per Section 447 of the 2013 Act are similar, except that under Section 447, fraud includes ‘acts with an intent to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.’

However, an auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account/financial statements of the company. For example,

- an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;
- if the password of a key managerial personnel is stolen and misused to access confidential/restricted information, the effect of the same may not be determinable by the management or by the auditor;
- if an employee is alleged to be carrying on business parallel to the company’s business and has been diverting customer orders to his company, the auditor may not be able to detect the same since such sales transactions would not be recorded in the books of the company.

32. Therefore, for the purpose of Section 143(12) the auditor would need to consider the requirements of the SAs, insofar as they relate to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.

Reporting on Suspected Offence involving Frauds noted during Audit/Limited Review of Interim period Financial Statements/Results and Other Attest Services

33. Section 143(12) of the 2013 Act, as amended by the Companies (Amendment) Act, 2015 is effective from December 14, 2015. Whilst Section 143 deals with auditor’s duties and responsibilities under the Act with respect to financial statements prepared under the Act, the auditors, normally, also perform other attest services in their capacity as auditors of the company. For example, Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 requires the statutory auditor to perform limited review/audit of the quarterly financial results published by the listed companies. The auditor may also be engaged by the Board of Directors of the company to carry out the audit of interim financial statements prepared by the management and report on such interim financial statements to the Board of Directors. The auditor may also have been engaged to perform tax audit under the Income-tax Act, 1961.

34. In the case of the aforesaid attest services for financial years beginning on or after 1st April, 2014, the following needs to be considered:

- a. Such attest services may not be pursuant to any requirement of the 2013 Act. They may rather be rendered to meet the specific requirements of the company (such as complying with the Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, to meet the requirements of the Board of Directors of the company, etc.).
- b. Wherever a statute or regulation requires such attest services to be performed by the auditor of the company, the auditor should consider the requirements and provisions of Section 143(12) since any such work carried out by the auditor during such attest services could be construed as being in the course of performing his duties as an auditor, albeit not under the Companies Act, 2013.
- c. The objective and scope of such attest services and the procedures performed by the auditor may not be of the same extent and level as in the case of the audit of the financial statements prepared under the 2013 Act. For example, the quarterly results under Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements), Regulations 2015 may be subject to a limited review performed in accordance with the Standards on Review Engagements and hence would not have been performed in accordance with the SAs.

35. ***If an offence of fraud in the company by its officers or employees that is identified/noted by the auditor in the course of providing such attest services as referred above, is of such amount/s as specified in Rule 13 of the Companies (Audit and Auditors) Rules, 2014 [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015] which the auditor uses or intends to use when performing the audit under the 2013 Act, then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder, as specified in this Guidance Note.***

Reporting Responsibility in case of Suspected Offence involving Fraud noted during Performance of Permitted Non-attest Services

36. Auditors could be engaged to provide non-attest services that are not prohibited under Section 144 of the Act. It is possible that the auditor, when providing such non-attest services may become aware of a fraud that is being or has been committed against the company by its officers or employees. A question that arises is – should the auditor report under Section 143(12) on frauds noted in the course of providing non-attest services?

37. It may be noted that reporting under Section 143(12) arises only if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company.

38. *If an offence of fraud in the company by its officers or employees that is identified/noted by the auditor in the course of providing such non-attest services as referred above, is of such amount/s as specified in Rule 13 of the Companies (Audit and Auditors) Rules, 2014 [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015] which the auditor uses or intends to use when performing the audit under the 2013 Act, then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder, as specified in this Guidance Note.*

Reporting on Frauds detected by the Management or Other Persons and already Reported under Section 143(12) by Such Other Person

39. Paragraph 4 of SA 240 states and clarifies that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In the context of the 2013 Act, this position is reiterated in Section 134(5) which states that the Board report shall include a responsibility statement, *inter alia*, that the directors had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities. ***Based on the above, it may be considered that Section 143(12) envisages the auditor to report to the Audit Committee or the Board of Directors and, where applicable, to the Central Government an offence involving fraud/suspected fraud against the company by its officers or employees only if he is the first person to identify/note such instance in the course of performance of his duties as an auditor.***

The auditor, in the course of the performance of his duties as an auditor, is required to make inquiries with the management and the Board or Audit Committee about reported or identified/detected instances of fraud through any other internal or external sources and, consequently, the auditor may become aware of those frauds which have been/are being remediated/dealt with by them. Though the auditor becomes aware of such frauds when he/she is informed of the same by the management, he/she, *per se*, has not identified them on his/her own and is, therefore, not the first person to identify the fraud in those cases.

For example, in the case of Banks and NBFCs there is a requirement of reporting frauds to the Audit Committee/Board and to the Reserve Bank of India and, hence, to the extent such cases have already been identified and reported by the management, the auditor cannot be considered as the person who first identified them. Further, many companies have or are required to have a vigil/whistle blower mechanism through which instances of fraud may have already been reported.

Accordingly, in case a fraud has already been reported or has been identified/detected by the management or through the company's vigil/whistle blower mechanism and has been/is being remediated/dealt with by them and such case is informed to the auditor, the latter will not be required to report the same under Section 143(12) since he has not per se identified the fraud.

The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

For example, in a fraud involving vendor payments, if the company identified the fraud and its nature and cause through its internal control mechanism but did not identify all the vendor accounts involved in the fraud that were identified by the auditor, it may need to be considered that the fraud was not identified in all aspects by the management and the auditor may need to report the same under Section 143(12) of the 2013 Act.

40. Since reporting on fraud under Section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, ***if a suspected offence involving fraud has already been reported under Section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same to the Central Government under the section since he has not per se identified the suspected offence involving fraud.***

41. ***In case the fraud involves or is expected to involve an amount of rupees one crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence involving fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed (Refer paragraphs 96 to 100). If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.***

Reporting on Suspected Offence Involving Fraud in case of Consolidated Financial Statements

42. As per Section 129(4) of the 2013 Act, the provisions relating to audit of the standalone financial statements of the holding company shall also apply to the audit of the consolidated financial statements. Since the audit of the consolidated financial statements has also been made one of the duties of the auditor, a question that arises is – should the auditor report on suspected offence involving frauds that may have taken place in any of the subsidiaries, joint ventures, associates of the company?

III.938 Auditing Pronouncements

43. In the case of an audit of consolidated financial statements, as per paragraph 1 of SA 600 "Using the Work of Another Auditor" read with paragraph 9 of SA 200, when the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

It may be noted that the auditors of foreign components and those components that are not companies as defined under the 2013 Act are not covered under the requirements of Section 143(12), since it applies only to the auditor of the company under the Companies Act 2013.

Accordingly, the auditor of the parent company is not required to report on frauds under Section 143(12) which are not being or have not been committed against the parent company by the officers or employees of the parent company and relate only to:

- a) ***A component that is an Indian company, since the auditor of that Indian company is required to report on suspected offence involving fraud under Section 143(12) in respect of such company; or***
- b) ***A foreign corporate component since they are not covered by the Companies Act, 2013; or***
- c) ***A component that is not a company since the component auditors' of such components are not covered under Section 143(12).***

However, the auditor of the parent company in India will be required to report on suspected offence involving fraud in the components of the parent company, if (a) such fraud is being or has been committed by employees or officers of the parent company; (b) if such suspected offence involving fraud in the component is against the parent company; and (since the requirement for reporting under Section 143(12) arises only if the suspected offence involving fraud is being or has been committed against the company by officers or employees of the company), if:

- (i) ***the principal auditor identifies/detects such suspected offence involving fraud in the component "in the course of the performance of his duties as an auditor" of the consolidated financial statements; or***
- (ii) ***the principal auditor is directly informed of such a suspected offence involving fraud in the component by the component auditor and the management had not identified/is not aware of such suspected offence involving fraud in the component. (Also refer paragraphs 36 to 38 above.)***

Reporting under Section 143(12) When the Suspected Offence Involving Fraud Relates to Periods prior to Coming into Effect of the 2013 Act

44. An auditor, in the current year, may identify a possible or committed fraud that relates to an earlier year covered under the 1956 Act. The question that arises is - whether such frauds should also be reported under Section 143(12).

45. Requirements similar to Section 143(12) of the 2013 Act were not prescribed in the 1956 Act. Even the reporting under CARO, 2003 only required the auditors to report to the members on any fraud on or by the company that had been noticed or reported during the year.

As such, auditors would not have reported on frauds as envisaged under Section 143(12) in those years. Accordingly, ***in case of fraud relating to earlier years to which the Companies Act, 1956 was applicable, reporting under Section 143(12) will arise only if the suspected offence involving fraud is identified by the auditor in the course of performance of his duties as an auditor during the financial years beginning on or after April 1, 2014 and to the extent that the same was not dealt with in the prior financial years either in the financial statements or in the audit report or in the Board's report under the Companies Act, 1956.***

When does an Auditor Commence Reporting under Section 143(12) – Based on Suspicion - Reason to Believe – Knowledge – or on Determination of Offence?

46. Section 143(12) states that an auditor should report under the Section if he has “reason to believe” that an offence involving fraud is being or has being committed in the company by its officers or employees. Similarly, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, also specifies the threshold for reporting as “reason to believe”. The Form ADT – 4 in which the auditor is required to report to the Central Government uses the term “suspected offence involving fraud”.

47. ***It is important to understand the terms “reason to believe”, “knowledge” and “suspected offence involving fraud” to determine the point of time when the reporting requirement is triggered for an auditor under Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015.***

- ‘Suspicion’ is a state of mind more definite than speculation, but falls short of knowledge based on evidence. It must be based on some evidence, even if that evidence is tentative – simple speculation that a person may be engaged in fraud is not sufficient grounds to form a suspicion. Suspicion is a slight opinion but without sufficient evidence.
- For 'reason to believe' to come into existence, it cannot be based on suspicion. There needs to be sufficient information or convincing evidence to advance beyond suspicion that it is possible someone is committing or has committed a fraud. For example,

III.940 Auditing Pronouncements

identification of fraud risk factors in itself cannot cause 'reason to believe' that a fraud exists.

- The term 'reason to believe' creates an objective test. SA 240 specifies the requirements to be complied by the auditors in assessing and responding to the risk of fraud in an audit of financial statements. For example, when complying with the requirements of SA 240, an auditor might be considered to have reasons to believe that a fraud has been or is being committed if he had actual knowledge of, or possessed information which would indicate to a reasonable person, that another person was committing or had committed a fraud.
- The term 'reason to believe' which has been used in the SAs indicate that it arises when
 - Evaluating audit evidence and information provided; or
 - Evaluating misstatements, including deviations noted on audit sampling and further audit procedures carried out; or
 - Exercising professional skepticism.
- ***Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, has used the terms 'reason to believe' and 'knowledge' (of fraud). The condition of 'reason to believe' would be met if on evaluation of all the available information with the auditor and applying appropriate level of professional skepticism the auditor concludes that a fraud is being or has been committed in the company.***
- ***Having 'knowledge' means knowing 'that' something. In the case of reporting on fraud under Section 143(12), it occurs when the auditor has sufficient reason to believe that a fraud has been or is being committed on the company by its officers or employees. This implies that there exists a fraud.***
- Whilst Section 143(12) uses the term 'offence involving fraud' and the Form ADT-4 uses the term "suspected offence involving fraud". ***As per paragraph 3 of SA 240, although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.*** Determination of "offence" is legal determination and accordingly, the auditor will not be able to determine whether under legal parlance an "offence or suspected offence involving fraud" has been or is being committed against the company by its officers or employees,

48. Accordingly, ***based on a harmonious reading of Section 143(12), Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015 and Form ADT - 4, reporting on fraud in the course of performance of duties as auditor, would be applicable only when the auditor has reason to***

believe and has knowledge that a fraud has occurred or is occurring i.e., when the auditor has evidence that a fraud exists.

Can the Auditor apply the Concept of Materiality for Reporting on Fraud?

49. The concept of materiality is fundamental for setting up an appropriate system of internal control, preparation of financial statements and its audit. Due to its inherent limitations, internal control systems cannot provide absolute assurance that no fraud or error has taken place. Since the auditor is required to comply with the SAs in performance of duties as an auditor, the audit will be performed applying the concept of materiality provided in the SAs.

50. Section 143(9) requires the auditor to comply with the SAs, which, *inter alia*, includes consideration of materiality, applying materiality in evaluating misstatements and disposition of the same.

51. The auditor should continue to apply the concept of materiality in performing the audit in accordance with SA 320 "Materiality in Planning and Performing an Audit".

52. Fraud results in misstatement of financial statements. The SAs outline the procedures to be performed by an auditor in case a misstatement due to fraud is identified by the auditor. For example, paragraph A52 of SA 240 states that in evaluating and disposing the misstatements identified, the auditor should consider the requirements of SA 450 "Evaluation of Misstatements Identified during the Audit".

53. SA 450 considers the concept of materiality in classifying the manner of disposition of misstatements, including those arising from fraud. Misstatements arising from fraud, will need to be communicated to the management and/or those charged with governance as required under paragraphs A21 to A23 of SA 450 and also reported to the Central Government in accordance with the requirements specified in Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended, in case the amount involved or expected to involve is individually Rupees One Crore or more.

54. Materiality is applicable wherever the amount is quantifiable. Where the amount is not quantifiable, the auditor should apply professional judgement to estimate the likelihood of the amount exceeding the aforesaid limit of Rupees One Crore prescribed for reporting to the Central Government. For this purpose it can be based on management estimate or reasonable range of estimate made by the auditor.

55. Subsequent reporting may be required if the amount initially estimated was lower than the aforesaid limit but was eventually determined to be higher than such limit. Under these circumstances, the timeline for reporting under Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, will commence when the amount involved is determined to be in excess of such limit.

Should the Auditor Report under Section 143(12) in case of Corruption, Bribery, Money Laundering and Non-compliance with Other Laws and Regulations

56. In case of corruption, bribery and money laundering, the direct effect of such act (benefit or penal consequence) is on the company.

57. The auditor should comply with the relevant SAs with regard to illegal acts (e.g. SA 240 and SA 250) when performing the audit. If the auditor, in the course of performance of his/her duties as the auditor, comes across instances of corruption, bribery and money laundering and other intentional non-compliances with laws and regulations, the auditor would need to evaluate the impact of the same in accordance with SA 250 to determine whether the same would have a material effect on the financial statements.

58. ***With respect to reporting under Section 143(12), consequent to corruption, bribery, money laundering and other intentional non-compliance with other laws and regulations, the auditor should consider, for the purpose of reporting, whether such acts have been carried out by officers or employees of the company for the purpose of reporting and also take into account the requirements of SA 250, particularly paragraph 28 of SA 250 read with paragraphs A19 and A20 thereof.***

For example, if the auditor comes to know that the company has filed a fraudulent return of income to evade income tax, he may have to report this fraud under Section 143(12) irrespective of whether adequate provision has been made in the books of accounts or not.

It may be noted that the proviso to Section 147(2) in the context of punishment to auditors for contravention with the provisions, inter alia, of Section 143 of the 2013 Act, states "if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees."

SECTION III :APPLICABILITY OF STANDARDS ON AUDITING

59. Since reporting on fraud arises only in the course of performing duties as an auditor, the auditor should, *inter alia*, take into consideration the requirements of the following provisions of the SAs (Refer paragraphs 60 to 73 below) for purposes of designing audit procedures which are effective in identifying and assessing the risks of material misstatement due to fraud. ***These are in addition to SA 240 and SA 250 which Standards are required to be mandatorily complied in entirety insofar as they relate to audit of the financial statements and also for reporting on fraud under Section 143(12), as amended by the Companies (Amendment) Act, 2015 and Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015.***

60. Professional Skepticism (SA 200)

Paragraph 13(l) – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Paragraph A18 - Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Paragraph A19 - Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Paragraph A20 - Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist

III.944 Auditing Pronouncements

and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Paragraph A21 - The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

Paragraph A22 - The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

61. Audit Documentation

As per paragraph 44 of SA 240 and paragraph 32 of SA 315, the auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315 would include:

- a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; (Refer **Appendix 1**) and
- b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

As per paragraph 45 of SA 240 and paragraph 28 of SA 330, the auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330 shall include:

- a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- b) The results of the audit procedures, including those designed to address the risk of management override of controls.

The auditor should document communications about fraud made to management, those charged with governance, regulators and others.

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

62. Inquiries with those Charged with Governance

Paragraph 20 of SA 240 states that unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

Paragraph 21 of SA 240 requires that the auditor makes inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management. (Refer **Appendix 2**)

Paragraph A20 of SA 240 states that an understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of the management.

63. Communications with those Charged with Governance

Paragraph 40 of SA 240 states that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Paragraph 41 of SA 240 requires that unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspect's fraud involving:

- a) Management;
- b) Employees who have significant roles in internal control; or
- c) Others where the fraud results in a material misstatement in the financial statements.

The auditor should communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor should communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

Paragraph 42 of SA 240 requires the auditor to communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities.

64. Risk Assessment Procedures and Related Activities

Paragraphs 5 to 24 of SA 315 require the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor is required to perform procedures to obtain information for use in identifying the risks of material misstatement due to fraud.

65. Inquiries with Management and Others within the Entity

Paragraph 17 of SA 240 requires the auditor to make enquiries of management regarding:

- a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
- b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;
- c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

Paragraph 18 of SA 240 requires the auditor to make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Refer **Appendix 2**)

66. Identification and Assessment of the Risks of Material Misstatement Due to Fraud

In accordance with paragraph 25 of SA 315, the auditor needs to identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 of SA 240 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. As per paragraph 27 of SA 240, the auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks.

67. Responses to the Assessed Risks of Material Misstatement

In accordance with paragraph 5 of SA 330, “The Auditor’s Responses to Assessed Risks”, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.

Paragraph 29 of SA 240 requires that in determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should:

- a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor’s assessment of the risks of material misstatement due to fraud for the engagement;
- b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management’s effort to manage earnings; and
- c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

Further, in accordance with Paragraph 6 of SA 330, the auditor is also required to design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

68. Evaluation of Misstatements Identified during the Audit

Paragraph A52 of SA 240 states - “SA 450, “Evaluation of Misstatements Identified during the Audit”, and SA 700, “Forming an Opinion and Reporting on Financial Statements”, establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor’s opinion in the auditor’s report.”

Paragraph A50 of SA 240 states - Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative net effect is not material, may be indicative of a risk of material misstatement due to fraud.

69. Analytical Procedures

The use of analytical procedures as risk assessment procedures is dealt with in SA 315. Use of analytical procedures as substantive procedures (substantive analytical procedures) and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements is dealt with in SA 520. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate

III.948 Auditing Pronouncements

matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement especially risks of material misstatement due to fraud.

The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk.

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Paragraph 6 of SA 520)

If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- (b) Performing other audit procedures as necessary in the circumstances. (Paragraph 7 of SA 520)

The auditor should evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud (Paragraph 22 of SA 240).

70. Review of Accounting Estimates

Paragraph 6 of SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" requires the auditor to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework, the accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable, and related disclosures in the financial statements are adequate.

The auditor should review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud (Paragraph 32(b) of SA 240).

71. Related Parties

Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risk of material misstatement due to fraud (Paragraph A6 of SA 550)

If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risk of material misstatement due to fraud in accordance with SA 240 (Paragraph 19 of SA 550)

If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of SA 240, perform certain audit procedures to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures (Paragraph A33 of SA 550).

72. Written Representations

SA 580, "Written Representations", establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. As per paragraph A57 of SA 240, in addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

73. Inquiries with Internal Auditors

SA 610, "Using the Work of Internal Auditors", establishes requirements and provides guidance in audits of those entities that have an internal audit functions. For those entities that have an internal audit function, paragraph 19 of SA 240 states that the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

SECTION IV: TECHNICAL GUIDANCE ON REPORTING ON FRAUD UNDER SECTION 143(12)

74. The duty of auditor with respect to fraud in the course of his performance of duties as an auditor is to comply with the requirements of SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

75. Therefore, the auditor is required to carry out the following procedures as specified in SA 240:

- a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

III.950 Auditing Pronouncements

c) To respond appropriately to identified or suspected fraud.

76. In addition to the above procedures, the auditor is required to report on fraud in accordance with Section 143(12) of the 2013 Act. For purposes of reporting under Section 143(12) to the Audit Committee/Board and the Central Government, the auditor is required to carry out certain specific procedures with respect to the identified offence involving fraud against the company by its officers or employees.

The objective of this part of the Guidance Note is to provide supplementary guidance to the SAs for consideration by auditors when complying with the requirements of Section 143(12) of the 2013 Act.

77. Modifications to terms of Engagement with regard to Reporting on Fraud under Section 143(12)

Reporting by the auditor on fraud is not a separate engagement and is a part of the performance of the duties as an auditor of the financial statements of the company under the 2013 Act.

The terms of engagement between the auditor and the client as required under SA 210 will require certain modifications to incorporate the management's responsibility with regard to fraud and the auditor's reporting responsibility for reporting under Section 143(12).

The following clauses may be added to the auditor's engagement letter with regard to reporting on fraud under Section 143(12):

As part of Auditor's Reporting Responsibilities:

In accordance with the provisions of Section 143(12) and 143(13) of the 2013 Act, if in the course of performance of my/our duties as auditor, I/we have reason to believe that an offence of fraud is being or has been committed in the Company by officers or employees of the Company, I/we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, *inter alia*, requires me/us to

In case of a fraud involving or expected to involve less than rupees one crore, to report the matter to the Audit Committee constituted under section 177 of the Companies Act, 2013 or to the Board immediately but not later than two days of my/our knowledge of the fraud and our report would specify the following:

- Nature of fraud
- Approximate amount involved; and
- Parties involved

In case of a fraud involving rupees one crore or more, I/we shall make a report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me/us to forward the same to the Central Government. Such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or

be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As part of Management's Responsibility:

Management is responsible for taking proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities.

Management is responsible to provide me/us access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the Act.

78. Fraud Risk Factors – Assessed Risk of Material Misstatement due to Fraud

SA 240 provides examples of fraud risk factors that may be faced by auditors in a broad range of situations, specifically relating to the two types of frauds relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets.

Examples of fraud risk factors stated in SA 240 and additional examples of fraud risk factors are given in **Appendix 3** for consideration by auditors during the course of their audit.

Although the fraud risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different fraud risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of fraud risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

79. Audit Procedures to Address Assessed Risk of Material Misstatement due to Fraud

Based on the nature, size and circumstances of the fraud risk factors, the auditor will have to design appropriate audit procedures to address the assessed risk of material misstatement due to fraud. SA 240 provides examples of possible audit procedures to address the assessed risk of material misstatement due to fraud.

III.952 Auditing Pronouncements

Additional examples of possible audit procedures to address the assessed risk of material misstatement due to fraud are given in **Appendix 4** for consideration by auditors during the course of their audit.

Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance.

80. Stages of Identification of Fraud

The information about possible offence involving fraud, obtained by the auditor during the course of his audit, can be classified into four stages:

- a) Speculation.
 - b) Suspicion.
 - c) Reason to Believe.
 - d) Knowledge.
- a) **Speculation** - "Speculation" refers to information from unrelated source which is a rumour, hearsay, gossip, assumption, guess, thought or supposition. Examples of information which could be classified as speculation are provided below:
- Rumours about management accepting kick-backs from suppliers/service providers for awarding contracts, but no proof.
 - Based on specific industry risk, there is an assumption that there will be transactions involving cash and money laundering.
 - Media reports indicating that the company is planning to invest in totally unrelated, high-risk business.
 - Board of Directors consisting of some persons exposed to illegal acts.
 - Gossip that certain business groups/entities are front end for an undisclosed owner.
 - Rumour that promoters of certain companies have accounts in tax havens and are involved in circulating monies through such tax havens.

At this stage, the auditor may have to perform engagement risk assessment procedures to determine if there is any merit in the speculation and whether or not to accept or continue with the engagement and the level of staffing that will be required to address any fraud risk factors identified from the above.

- b) **Suspicion** – 'Suspicion' is a state of mind more definite than speculation, but falls short of knowledge based on evidence. It must be based on some evidence, even if that evidence is tentative. Suspicion is a slight opinion but without sufficient evidence.

In other words, a “suspicion” will lead to identification of fraud risk factors during the course of audit. Examples of information which could be classified as suspicion are provided below:

- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.
- Accounting and information systems those are not effective, including situations involving significant deficiencies in internal control.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Use of business intermediaries for which there appears to be no clear business justification.
- Domination of management by a single person or small group (in a non-owner managed business) without compensating controls.
- Overly complex organisational structure involving unusual legal entities or managerial lines of authority.
- The practice by management in maintaining or increasing the entity’s stock price or earnings trend.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions.
- Significant related party transactions which appear to be not in the ordinary course of business or with related entities not audited or over which the auditor does not have information.

At this stage, the auditor will have to identify the information leading to “suspicion” as “fraud risk factor” and design appropriate audit procedures to address this assessed risk of misstatement due to fraud.

c) **Reason to Believe** - ‘Reason to believe’ indicates that the matter should be more than just a suspicion. ‘Suspicion’ when corroborated with supporting evidence can provide ‘reason to believe’.

Examples of information which could be classified as “reason to believe” are provided below:

- Material misstatement identified during the course of audit.
- Identification of any material weakness in the internal controls.

III.954 Auditing Pronouncements

- Significant related party transactions not at arm's length and not supported by a proper business rationale.
- Sudden resignation of an employee belonging to the senior management and when proper reason is not assigned for his leaving.
- Resistance from the management with regard to certain disclosures in the financial statement.
- Material discrepancies between book stock and physical stock.
- Acquisition of significant assets which are unrelated to the business.
- During the course of perusal of the bank statements, when the auditor observes frequent transfer in and transfer out of funds from a particular account balance belonging to the promoter or an employee.
- Matters reported through the whistle blower mechanism on an incidence of fraud.
- Notices from regulators and government authorities on violations of laws and regulations.
- E-mail or written communication received directly by the auditor from a whistle blower.

At this stage the auditor has performed planned procedures to address the assessed risk of misstatement due to fraud. Certain evidences, which he obtained and evaluated during this process, indicate that there is a "reason to believe" that an offence involving fraud has been or is being committed. The auditor would now be required to carry out procedures as referred to in paragraphs 83 and 84 with a higher level of professional skepticism with a view to obtain more persuasive evidence to enable him to conclude whether he has "reason to believe" or has "knowledge" of fraud.

d) **Knowledge** – "Knowledge" indicates "reason to believe" with more persuasive evidence based on further procedures performed by the auditor. Examples of information which could be classified as "knowledge" are provided below:

- Material misstatement identified during the course of audit not supported by appropriate rationale/explanation from the management, indicating that the misstatement was intentional.
- Identification of any material weakness in the internal controls which has resulted in material damage/huge loss for the company.
- Significant related party transactions not at arm's length and not supported by appropriate evidence. Management is not able to provide appropriate rationale/substantiation for undertaking such transactions and such transactions may be prejudicial to the interests of the shareholders, based on the materiality determined by the auditor.
- Sudden resignation of an employee belonging to the senior management. On performing further procedures, it is noted that the employee had committed an offence involving fraud.

- Resistance from the management with regard to certain disclosures in the financial statements. On further inquiry, it comes to light that management had concealed certain information from the bankers/regulators and hence the resistance to disclose.
- Material discrepancies between book stock and physical stock. On examination, the auditor noted that the unit of measures were misstated for several items as against a one-off instance, which indicates that the misstatement could be intentional.
- Acquisition of significant assets which are unrelated to the business. On further inquiry with the project department, it appears that the acquisition was made to accommodate a related party or boost the sales of a related party.
- During the course of perusal of the bank statements, when the auditor observes frequent transfer in and transfer out of funds from a particular account balance belonging to the promoter or an employee. On further inquiry and procedures, the auditor notes that the employee involved was the person who is involved in preparing bank reconciliation statements (BRS) and there is no review of the work performed by this staff.
- Matters reported through the whistle blower mechanism on an incidence of fraud and the procedures performed by the management to investigate the reported matter were biased to protect the interests of the persons against whom the allegations were made.

At this stage, the auditor has “knowledge” of fraud and therefore, the auditor’s responsibility to report on the suspected offence of fraud to the Audit Committee constituted under section 177 / to the Board or to the Central Government, as applicable, based on the amount involved or expected to be involved, is triggered.

81. Section 143(1) of the Act requires the auditor, *inter-alia*, to perform the following inquiries and determine if any specific reporting to the members of the company is required under the said section:

- (a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) Whether loans and advances made by the company have been shown as deposits;
- (e) Whether personal expenses have been charged to revenue account;
- (f) Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment,

III.956 Auditing Pronouncements

and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Any adverse comment on the above may also be considered as matters where the auditor has sufficient reason to believe that a suspected offence involving fraud is being or has been committed.

82. A decision tree summarising the action required to be carried out by an auditor at different stages of information/extent of evidence obtained is provided as part of the overview to this Guidance Note.

83. Audit Procedures If Auditor has reasons to Believe a Fraud has Occurred or is being Carried Out

As discussed in the earlier sections of this Guidance Note, Section 143(12) of the 2013 Act requires the auditor to report to the Audit Committee constituted under section 177 / to the Board or to the Central Government, as applicable, if he has “reason to believe” that an offence of fraud is being or has been committed in the company by officers or employees of the company, based on the amount involved or expected to be involved. Clearly, section 143(12) does not envisage reporting in Form ADT 4 by the statutory auditor during the “speculation” and “suspicion” stages. During these stages, the auditor’s procedures would be as provided under the SA 240. Having reached the stage of “reason to believe”, the auditor would be guided by the requirements of paragraphs 83 and 84 of this Guidance Note.

Examples of audit procedures which the auditor can perform when he has “reason to believe” that an offence involving fraud is being or has been committed is given below:

- a. Evaluating the evidences obtained or misstatements identified with professional skepticism.
- b. Introducing elements of unpredictability/surprise in carrying out specific audit procedures (for example, visiting certain sales locations normally not visited at year end to evaluate if there are any “Billed but Not Delivered” sales transactions).
- c. If considered necessary, recommending to the Board or Audit Committee to involve experts such as information technology specialists, forensic experts or fair valuation experts, etc., to carry out data analytics and investigation (Refer paragraph 84 below).
- d. Seeking additional audit evidence from sources outside of the entity being audited. For example, external confirmations which could be tailored to specific circumstances such as confirming the terms and conditions relating to sale, confirming the occurrence of specific transactions, etc.
- e. Focussed testing on period-end and year-end journal entries by a senior member of the engagement team.

- f. Carrying out a more critical evaluation and retrospective testing of accounting estimates to evaluate the reasonableness of management's judgement and existence of management bias.
- g. Consulting with experts to evaluate unusual and complex transactions.
- h. Performing certain procedures specific to account balance when such evidences particularly relate to any specific class of transaction or account balance. For example, in addition to sending written confirmations, major customers and suppliers could be directly contacted in order to seek more or different information.
- i. Where related party transactions are involved, critically evaluating the business rationale of the transactions and arm's length nature of such transactions.
- j. Re-performing certain critical reconciliations carried out by the entity.

84. Working with the Board or the Audit Committee in case the Auditor has Reasons to Believe a Fraud may Exist

There could be circumstances where the auditor identifies misstatements in account balance where a fraud or a significant risk factor was identified by him and therefore has reason to believe that a fraud may exist. However, the auditor may not have "knowledge" that a fraud actually exists. As per the SAs, the auditor may communicate such misstatements to the management and request them to carry out additional reviews to ensure that there are no other undetected misstatements.

The auditor may perform parallel procedures or work with the management to identify any other misstatement due to fraud within those account balances that may have remained undetected.

The outcome of such audit procedures will help the auditor conclude whether he has knowledge, that the suspected offence involving fraud has been or is being committed.

85. It may be noted that the above procedures (Refer paragraphs 83 and 84) represent enhanced audit procedures which the auditor carries out in the course of his audit with professional skepticism with the primary objective to ensure that the financial statements are not materially misstated due to fraud. The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.

Further, although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determination of whether fraud has actually occurred. Therefore, an auditor cannot make an assertion that an 'offence' involving fraud has been or is being committed against the company. Accordingly, in Form ADT – 4 the terminology used is 'suspected offence involving fraud'.

86. Reporting to the Board or Audit Committee on Auditor's Reason to Believe and Knowledge of Fraud against the Company by Officers or Employees of the Company

Sub-Rules (2) and (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, requires the auditor to report to the Board or the Audit Committee, as the case may be, immediately but not later than two days, after he comes to (have) knowledge of the fraud.

Sub-Rules (3) and (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015], require that in case of fraud involving an amount less than Rupees One Crore, the auditor should report the matter to the Audit Committee constituted under section 177 of the Companies Act, 2013 or the Board of Directors. The report should specify the following:

- Nature of fraud with description
- Approximate amount involved; and
- Parties involved

If the amount involved in the fraud or is expected to be involved is Rupees One Crore or more, the auditor is required to seek the reply or observations of the Board or the Audit Committee within forty-five days of such reporting.

The Rule does not prescribe the form or format in which the auditor should communicate to the Board or the Audit Committee.

87. Therefore, the auditor may use the Form ADT – 4 itself to report to the Board or Audit Committee duly filling in the necessary details, other than those relating to items (11), (12) and (14) of the Form relating to date of receipt of response from the Board or Audit Committee; the auditor's opinion if the reply of the Board or Audit Committee was satisfactory; and the details of steps taken by the company in this regard. Refer **Appendix 5** for illustrative format of reporting to the Board or the Audit Committee.

88. The auditor may send additional details of the basis on which the fraud is suspected, the period to which it relates to and the basis of estimating the amounts involved, to enable the Board or Audit Committee to pursue the matter further.

89. It may be noted that the timeline for reporting under Section 143(12) starts immediately as soon as the auditor has knowledge of the fraud. The auditor is not required to investigate the fraud so as to establish the entire magnitude, the period, the *modus operandi* and the persons involved since the requirement of Section 143(12) read with the Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, is not that the auditor has to perform a forensic audit.

90. Obtaining Response from the Board or Audit Committee

When a fraud, individually involving or expected to involve Rupees One Crore or more, is reported by the auditor to the Board or Audit Committee, they are required to evaluate the matter, where applicable and take appropriate action on the matter, including, where required an investigation/forensic audit conducted either by appropriate internal specialists of the company or external specialists/experts, and respond to the auditor within 45 days of the date of the auditor's communication.

The Companies (Audit and Auditors) Amendment Rules, 2015 do not specify that the auditor should obtain response from the Board or the Audit Committee in case a suspected offence of fraud involving or expected to involve an individual amount of less than Rupees One Crore is reported to them. However, as a matter of prudence and professional skepticism, the auditor should obtain the response from the Board or the Audit Committee even for such fraud, as this will enable the auditor to obtain further assurance and management's assertion that the amount involved or expected to be involved in the fraud was less than Rupees One Crore.

91. It will be the responsibility of the Board or Audit Committee to have appropriate procedures performed, including, where required an investigation/forensic audit. The action taken by the Board or Audit Committee pursuant to receipt of communication from the auditor may involve investigation/forensic audit by their internal auditors, internal team of senior management or by an external agency. Based on the steps taken, including any investigation/forensic audit on the matter reported, they are required to reply to the auditors.

92. An investigation will include a planning stage, a period when evidence is gathered, a review process, and a report to the client. The purpose of the investigation, in the case of an alleged fraud, would be to discover if a fraud had actually taken place, to identify those involved, to quantify the monetary amount of the fraud (i.e., the financial loss suffered by the client), and to ultimately present findings to the client and potentially to court. It is normally not as in-depth as a forensic audit and in fact may not be performed by forensic auditors.

93. 'Forensic audit' refers to the specific procedures carried out in order to produce evidence. Specialised audit techniques are used to identify and to gather evidence to prove, for example, use of information technology and data retrieval tools, data analytics, interrogation (not interview), critical evaluation of evidence, motive, evaluating patterns of information, duration of the alleged fraud and how it was conducted and concealed by the perpetrators, etc.. Evidence may also be gathered to support other issues which would be relevant in the event of a court case. Such issues could include:

- the suspect's motive and opportunity to commit fraud;
- whether the fraud involved collusion between several suspects;
- any physical evidence at the scene of the crime or contained in documents;
- comments made by the suspect during interviews and/or at the time of arrest; and
- attempts to destroy evidence.

Forensic audit is a very specialised engagement, which requires highly skilled team members who have experience not only of accounting and auditing techniques, but also, among other things, of the relevant legal framework.

III.960 Auditing Pronouncements

94. Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, does not state what should be the contents of the reply of the Board or Audit Committee in case a report on a suspected offence involving fraud is received by them from the auditor where the amount involved in the fraud or is expected to be involved is Rupees One Crore or more. However, it would be reasonable to presume that the reply of the Board or Audit Committee will include the following:

- An acknowledgement of having received the report on fraud from the auditor.
- Brief description of the fraud or suspected fraud.
- The steps taken by them pursuant to receipt of the report, including:
 - a. The manner in which they have followed up on the matter reported to them;
 - b. Involvement of specialists, internal and/or external, who have carried out investigation/forensic audit on their behalf;
 - c. The period covered by such investigation/forensic audit;
 - d. Their assessment of areas impacted by the fraud – company locations, account balances, categories of assets/liabilities/income/expenses, categories of customers/vendors, off-balance sheet items, etc.
 - e. The conclusion drawn by them based on such investigation/forensic audit:
 - *If the Board or Audit Committee is in agreement with the auditor's conclusion on fraud* – the cause of the fraud, persons involved, estimate of amounts involved, the period to which the fraud relates to, steps taken by them to remediate the reasons which caused the occurrence of the fraud, including changes to the internal control systems or plans thereto, the action taken on the persons involved in the fraud (including filing of civil/criminal complaints with law enforcement agencies, disciplinary actions, etc.), the status of reporting the matter to any other regulator (e.g. RBI, Tax authorities, etc.).
 - *If the investigation/forensic audit ordered by them is in progress as on the date of the reply* - the status of the investigation, the persons allegedly involved in the fraud, any preliminary amounts quantified on the fraud, steps taken in the interim including any action taken on the persons allegedly involved in the fraud (including filing of civil/criminal complaints with law enforcement agencies, disciplinary actions, etc.), the status of reporting the matter to any other regulator (e.g. RBI, Tax authorities, etc.), remediation plan to prevent further occurrences, etc.
- A copy of the investigation report/report on the forensic audit (preliminary/draft/final) or the procedures performed/being performed by them to substantiate the items stated above.

95. There may be instances where the Board or the Audit Committee does not concur with the auditor's belief that a suspected offence involving fraud is being or has been committed. If the Board or Audit Committee is not in agreement with the auditor's belief that a suspected offence

involving fraud has been or is being committed, the persuasive reasons therefor with supporting evidence should be provided in their reply to the auditor along with the other matters described in paragraph 94 above.

96. Evaluating Reply of the Board or Audit Committee

The auditor should evaluate the reply of the Board or Audit Committee received by him in response to his report to them on the suspected offence involving fraud. Such evaluation is required to enable the auditor to state if he is satisfied or not satisfied with the reply of the Board or Audit Committee on the matter reported to them.

97. Whilst Sub-Rule (2)(b) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, requires the auditor to forward his report along with his comments on the reply received from the Board or the Audit Committee, Form ADT-4 requires the auditor to only state if he is satisfied or not satisfied with the reply of the Board or the Audit Committee. Accordingly, the comments of the auditor as specified in the Sub-rule implies the statement of the auditor in Form ADT – 4 about his satisfaction or otherwise with the reply of the Board or the Audit Committee. For this purpose, the auditor should review the reply from the Board or the Audit Committee with the supporting evidence provided to determine the reasonability of the same.

98. Where the Board or the Audit Committee has provided its reply on the basis of an investigation/forensic audit, the auditor is not expected to re-perform or carry out an independent investigation/forensic audit to validate the same. The auditor should, however, review the process followed by the investigation/forensic audit to gain comfort on:

- the scope of the investigation/forensic audit,
- the period covered,
- the persons covered,
- information gathered/obtained,
- specific scope exclusions or limitations, if any, in the investigation/forensic audit,
- the reasonableness of the amounts identified as involved based on his professional judgement and his understanding of the suspected offence involving fraud, and
- the competence, experience and seniority of the persons who conducted the investigation/forensic audit and their independence and objectivity.

99. If the Board or the Audit Committee disagrees with the belief of the auditor that a suspected offence involving fraud exists and provides evidence in this regard, the auditor would consider such evidence and perform such further procedures as may be necessary to determine if his initial belief was appropriate under the circumstances. In addition to reviewing the matters stated in paragraph 98 above with increased professional skepticism, the following additional factors should also be considered by the auditor:

III.962 Auditing Pronouncements

- Whether the evidence provided in the reply was available when the auditor initially concluded that there was a fraud or is it new evidence. If it was an evidence or information that was previously considered by the auditor, the reason why the company has considered the same evidence or information differently.
- The reliability of the evidence now provided considering the risk of bias to overlook a fraud that is existing.
- The persuasiveness of the company's evidence or information that the suspected offence involving fraud does not exist, that is included in the company's reply.

100. Based on the additional procedures carried out by the auditor after considering the factors stated in paragraph 99 above, pursuant to the reply of the company disagreeing with the initial belief of the auditor that a suspected offence involving fraud is being or has been committed, if the auditor is convinced that his initial suspicion was incorrect, the need for reporting the matter to the Central Government would not be applicable. This situation would arise only if the auditor did not have the evidence or information that is now provided as part of the reply or additional information has now been provided to the auditor and there is persuasive evidence now available to convince the auditor that the suspected offence involving fraud does not exist.

Reporting to the Central Government in Form ADT-4

101. It may be noted that Sub-rule (2)(b) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, requires the auditor to forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations) to the Central Government within 15 days of receipt of such reply. Consequently, it is not necessary that the auditor will always have 60 days to submit the Form ADT-4 to the Central Government since if the Board or the Audit Committee replies prior to 45 days of the date of the auditor reporting to them on the suspected offence involving fraud, the Form ADT - 4 will need to be submitted within 15 days of the receipt of reply from the Board or the Audit Committee. For example, if the Board or the Audit Committee replies in 24 days, the auditor will need to report in Form ADT-4 within 39 days i.e., 15 days of receipt of reply from the company.

102. If the auditor does not receive a reply to his communication to the Board or Audit Committee within 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations within 15 days of the expiry of the 45 days.

103. If the auditor receives a reply from the Board or Audit Committee within the stipulated time of 45 days of his communication to them, the auditor should within 15 days of receipt of the reply send his report in Form ADT-4 (Refer **Appendix 6**) to the Central Government stating the following:

- the date on which he received the reply;
- a gist of the reply or observations of the Board or the Audit Committee to his report;

- whether he is satisfied or not satisfied with the reply of the Board or Audit Committee;
- details of steps, if any, taken by the company in this regard (furnishing full details with references); and
- any other relevant information.

A copy of the reply received from the Board or Audit Committee should also be attached to the Form ADT-4 when submitting to the Central Government.

104. In case the auditor is not satisfied with the reply of the Board or the Audit Committee, he should state the reasons for the same in the Form ADT-4 as part of item 15 to the Form “Any other relevant information”. The reasons the auditor may not be satisfied with the reply of the Board or the Audit Committee may, *inter alia*, include any of the following:

- He is not satisfied with the competence or seniority/experience of the person who has carried out the investigation/forensic audit on behalf of the Board or the Audit Committee.
- If only an investigation was carried out but considering the nature, size, complexity, motive of the suspected offence involving fraud, it needed a forensic audit to be carried out, thereby impacting the comprehensiveness of the procedures performed by the Board or the Audit Committee. (Refer paragraphs 92 and 93)
- Facts produced by the auditor in his report were overlooked by the Board or the Audit Committee resulting in differing conclusions with that of the auditor.
- Based on further procedures performed and evaluation of the additional evidence or information provided, if the auditor is not convinced with the Board or the Audit Committee reply that the suspected offence involving fraud does not exist.
- Period of coverage, persons covered, and areas covered or scope of the investigation/forensic audit was not adequate or appropriate.
- If the reply of the Board or the Audit Committee does not include any of the matters referred to in paragraph 94 above and the auditor considers such matter to be significant for the Board or the Audit Committee to have considered in their reply.

105. Management Representation

SA 580 - “Written Representations”, establishes requirements and provides guidance on obtaining appropriate representations from management. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtains a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- a) The results of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

In addition to the management representations as discussed above, the auditor will be required to obtain certain specific representations with regard to the following:

III.964 Auditing Pronouncements

- a) Steps taken on fraud committed or being committed against the company.
- b) Matters included in the reply to the report of the auditor on suspected fraud.

Further when management is involved or suspected to be involved, the auditor should insist that the representations need to be provided by the Board or Audit Committee of the company.

Illustrative Management Representation Letter for steps taken by the Board or the Audit Committee on fraud reported by the auditor is provided in **Appendix 7**.

In the exceptional circumstances where the auditor has doubts about the integrity or honesty of those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

106. Audit Documentation and Quality Control

The documentation of the audit procedures performed from identifying the fraud risk till the identification of existence of fraud is critical as this would form the basis for matters reported to the Board or the Audit Committee and thereafter to the Central Government in Form ADT-4. This would also enable the auditor to demonstrate reporting in good faith to ensure protection under Section 143(13) and Section 456.

107. Auditors should, taking into account the provisions of SA 230, *inter alia*, consider the following items for being maintained as part of the audit documentation in connection with reporting under Section 143(12):

- a) Minutes of inquiries conducted with those charged with governance, internal auditors, senior management and relevant employees during the course of planning and minutes of engagement team discussions on fraud risk factors. (Refer paragraphs 61 and 62)
- b) The fraud risk factor or suspicion which led to identification of evidences which provided the knowledge to the auditor that a suspected offence involving fraud is being or has been committed. (Refer paragraphs 80.a and 80.b)
- c) Specific and additional audit procedures carried out by the auditor to address the assessed risk of material misstatement due to fraud. (Refer paragraphs 80.c, 80.d, 83 and 84)
- d) Memo documenting the professional judgement exercised by the auditor at various stages of performing the planned procedures.
- e) Details of evidences obtained during the course of performing the planned procedures. (Refer paragraphs 80.c, 80.d, 83 and 84)
- f) Copies of correspondences with the Board or Audit Committee on the procedures/investigations carried out, to conclude on matters reported by the auditor. (Refer paragraph 84)
- g) Copy of the report to the Board or Audit Committee along with attachments thereto. (Refer paragraphs 86 to 89)
- h) Copy of response received from the Board or the Audit Committee along with the supporting documents provided by them in their response. (Refer paragraphs 90 to 95)

- i) If an investigation/forensic audit was carried out by the Board or Audit Committee, how the auditor evaluated the competency and independence of the person who carried out the investigation and adequacy of the scope of work provided to them. (Refer paragraphs 96 to 100)
- j) Details of other procedures carried out to evaluate the reasonableness of investigation/forensic audit/action taken by the Board or Audit Committee in respect of the matter reported. (Refer paragraphs 96 to 100)
- k) Conclusions on whether or not the auditor was satisfied with the procedures carried out by the Board or the Audit Committee along with the basis and reasons therefor. (Refer paragraphs 98 to 104)
- l) If the auditor is satisfied with the Board or the Audit Committee response that the suspected offence involving fraud does not exist, the details of additional procedures performed, supporting evidence and additional evidence received by the auditor in this regard.(Refer paragraphs 99 and 100)
- m) Copy of the report submitted to the Central Government. The matters included in this report needs to be appropriately cross-referenced to the source documents. (Refer paragraphs 102,104 and paragraph 109)
- n) Management representations.(Refer paragraph 105)
- o) Documentation on how the auditor evaluated the implications of the suspected offence involving fraud on other aspects of audit and on the financial statements– whether the impact is isolated occurrence or pervasive (Refer paragraphs 106 and 110).
- p) If experts and specialists were involved in carrying out these procedures, then their work papers should also form part of the auditor’s work papers.
- q) Any memo on consultations the auditor had during the course of carrying out the procedures with regard to fraud.
- r) Evidence of a quality control review having been performed on the audit procedures carried out and the report submitted to the Board or Audit Committee and the Central Government. (Refer paragraph 108)

108. Whilst reporting under Section 143(12) is not a separate engagement from an audit of financial statements, it arises from such an audit, since reporting under Section 143(12) is consequent to any fraud noted in the course of performance of duties as auditor. Further, since the auditor is required to report to the Central Government in case of fraud against the company, and given the exceptional nature of circumstances, the auditor should ensure that the reporting under Section 143(12) is subject to quality control considering the provisions of SA 220 – “Quality Control for an Audit of Financial Statements”.

109. Whilst the Act or the Rules do not specify that the auditor should send a copy of the Form ADT-4 sent to the Central Government to the Board or the Audit Committee, the Act or the Rules do not prohibit the same. Accordingly, the auditor may send a copy of the Form ADT-4 and the documents annexed thereto to the Board or the Audit Committee for their information and records.

110. Evaluation of Impact on the Financial Statements, Audit Opinion on the Financial Statements and Internal Financial Controls

If a fraud has been noted and reported under Section 143(12), the auditor will have to evaluate the implications of the matter reported in the financial statements, on his audit opinion on the financial statements and on any other matter to be included in his report under Sections 143(1) to (3) including with regard to reporting on the adequacy and operating effectiveness of the internal financial controls. The following will need to be considered by the auditor in this regard:

- When the auditor has reason to believe that the management is involved in the fraud, how the auditor re-evaluated the risks of material misstatement due to fraud and reliability of the evidences previously obtained.
- When the auditor confirms that, or is unable to conclude whether the financial statements are materially misstated due to fraud, how the auditor evaluated the implications for the audit.

111. Consideration in Joint Audits

In case of joint audits, where a suspected offence involving fraud against the company by its officers or employees is identified/noted by one of the joint auditors, such joint auditor should communicate the same to the other joint auditor(s) to enable them to consider and evaluate if the same could exist in the areas/account balances audited by them and each of the joint auditor should individually comply with the requirements of this Guidance Note.

The reporting to those charged with governance and to the Central Government as required under Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015, may be carried out by the joint auditor who identified/noted the suspected fraud or by any or all of the joint auditors together.

When the reporting in Form ADT – 4 is carried out only by the joint auditor who identified/noted the suspected fraud, such joint auditor should provide a copy of the Form ADT – 4 to the other joint auditors.

112. Consideration of Disclosure of Frauds in the Board's Report

SA 720 – “The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements” requires the auditor to read the other information in documents that contain audited financial statements because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

Pursuant to the amendments to Section 143(12) of the Companies Act, 2013 read with Rule 13(3) and (4) of the Companies (Audit and Auditors) Rules, 2014 [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015], the auditor is required to report a fraud involving less than Rupees One Crore only to the Audit Committee or the Board of Directors. Such frauds may have been appropriately dealt with in the audited financial statements of the company. However, as per the aforesaid Rules, the Board of Directors' report is required to disclose the following information in respect of such frauds:

- Nature of fraud with description
- Approximate amount involved
- Parties involved, if remedial action not taken; and
- Remedial action taken

Since the Board's report also includes audited financial statements, the auditor should read the disclosures relating to fraud in the Board's report to determine if they are consistent with the matter reported by the auditor and dealt with in the audited financial statements. In case the auditor observes any material inconsistency in the disclosure in the Board' report in this regard, the auditor should consider the requirements of SA 720 to determine the manner of dealing with the inconsistency observed.

SECTION V: APPENDICES

APPENDIX 1

(Refer paragraph 61)

Illustrative Matters for Engagement Team Discussion on Fraud

Discussion among the engagement team

A discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion should place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

The discussion should occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

The discussion may include such matters as:

III.968 Auditing Pronouncements

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalise committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Illustrative matters for consideration during engagement team discussions on fraud risk factors

- What are the business risks that the entity is subject to?
- How might fraud, including fraudulent financial reporting, occur at the entity? How can it be concealed?

- Have there been any frauds that have been reported in the same industry as the entity? If so, is it possible that the fraud identified is applicable to the entity and should be considered?
- Where are the financial statements susceptible to material misstatement as a result of fraud or error?
- How could assets at the entity be misappropriated?
- Is there a high risk of management override of controls?
- What is the susceptibility of financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions?
- Are there circumstances that indicate earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting?
- Are there known external or internal factors affecting the entity that may create an incentive or pressure for management and others to commit fraud, provide the opportunity for fraud to be perpetrated, indicate a culture or environment that enables management or others to rationalise committing fraud?
- Is the financial stability or profitability of the entity threatened by economic, industry, or other operating conditions?
- Does the nature of the entity's operations provide opportunities to engage in fraudulent financial reporting?
- Does the entity have a complex or unstable organisational structure?
- Are there any unusual or unexplained changes in behavior or lifestyle of management and/or others?
- Have there been any actual frauds uncovered at the entity?
- If so, what was the circumstances surrounding the fraud and what was the outcome of the investigation?
- Did management and others take the appropriate actions to address the fraud?
- Have there been any allegations of fraud?

In addition to assessing the susceptibility to fraud, engagement teams may consider the following matters in addressing the fraud risk factors:

- What insights can be shared amongst engagement team members based on the knowledge of the entity?

III.970 Auditing Pronouncements

- Does each engagement team member understand the potential for material misstatements related to each audit area they have been assigned to?
- What types of circumstances, if encountered, during the engagement could indicate a possibility of fraud?
- What type of procedures might be selected to respond to possible fraud?
- Are there certain types of procedures that are more effective than others?
- Is the engagement team aware of the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud?
- How will the element of unpredictability be incorporated into the nature, timing and extent of the audit procedures to be performed?
- What happens if fraud is identified during the engagement?

APPENDIX 2

(Refer paragraphs 62 and 65)

Illustrative Checklist for Inquiries with Board/ Audit Committee, Management and Internal Auditor

Inquiries of Management and Others regarding the risk of fraud:

Document responses after each chart within the space provided.

Questions Regarding the Identification of Fraud Risks and Other Risks of Material Misstatement

The following questions are designed to identify fraud risks that are known to management. Questions may be directed to those individuals indicated:

Questions	Board/ Audit Committee	CEO	CFO	Internal Audit	Others
What are your views regarding the risks of fraud?	*	*	*	*	
Do you have knowledge of any actual or suspected fraud affecting the entity? If so, describe each instance including:	*	*	*	*	

Questions	Board/ Audit Committee	CEO	CFO	Internal Audit	Others
a. The individual's position within or relationship to the entity.					
b. Identification of others involved or that may have been involved in the matter and their relationship to the entity or any of its employees.					
c. The scheme used or possibly used to misstate the financial statement amounts and/or disclosures.					
d. Whether the misstatement or potential misstatement was detected in a timely manner by the internal controls, especially the antifraud programs and controls, established by management.					
e. If the misstatement or potential misstatement was not detected in a timely manner, indicate whether it was because the programs and controls were: <ul style="list-style-type: none"> i. Not in place ii. Improperly designed iii. Properly designed but not operating effectively. 					
f. How management (or others, such as the Audit Committee) became aware of the scheme used or possibly used to misstate the financial statements.					
g. The actual or potential effect on the financial statement amounts and/or disclosures.					
h. The actions that management and/or those charged with governance (e.g., the Audit Committee) took in response to each instance described (e.g., investigation, restating the financial statements). If no action was taken, please explain the reasons for that decision.					
i. Any disciplinary actions that management and/or those charged with governance (e.g., the Audit Committee) took with respect to the individual(s) involved in the matters described. If there was no disciplinary action taken, please indicate such and explain why no action was considered necessary.					
j. How management plans to prevent, deter, and detect the risks relating to such schemes in the future.					
Provide copies of reports on suspected fraud received from the cost	*				

III.972 Auditing Pronouncements

Questions	Board/ Audit Committee	CEO	CFO	Internal Audit	Others
auditors, secretarial auditors and erstwhile statutory auditors in the last year in terms of Section 143(12) of the Companies Act, 2013 and the Rules thereunder, along with the responses of the company provided to such persons and copies of reporting on fraud to any other regulatory authority.					
Are you aware of allegations of fraud or suspected fraud affecting the entity (e.g., received in communications from employees, former employees, analysts, regulators, short sellers, or other investors)? If so, describe each instance, addressing items (a) through (j) from the above question as applicable.	*	*	*	*	
Is the entity in compliance with laws and regulations that may have a material effect on the financial statements?	*	*	*		
Are you aware of tips or complaints regarding the entity's financial reporting (including those received through any internal whistleblower program, if such program exists) and, if so, what were your responses to such tips and complaints?	*	*	*		
Have you reported to those charged with governance on how the entity's internal control serves to prevent and detect material misstatements due to fraud?		*	*		
Are you aware of instances of management override of controls and the nature and circumstances of such overrides?				*	
<i>[To the extent necessary, expand inquiries of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the entity who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement;]</i>	*	*	*	*	*
Other: _____					

Documentation

Questions Regarding Processes to Prevent or Mitigate Fraud Risks

The following questions are designed to identify the processes, including absence thereof or weaknesses therein, to prevent or mitigate fraud risks. Questions may be directed to those individuals indicated:

Questions	Board or the Audit Committee	CEO	CFO	Internal Audit	Others
Does management perform an assessment of the risk that the financial statements may be materially misstated due to fraud (e.g., processes used to identify, analyse, and manage fraud faced by the entity)? If so, describe such processes, including the nature, extent, and frequency of such assessments.		*	*		
Describe your understanding about management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.	*	*	*	*	
Has the entity established programs and controls to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud? If so, describe such programs and controls, including how management monitors them.		*	*		
Describe how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.	*	*	*		
Has management communicated with those charged with governance (e.g., Audit Committee; others with equivalent authority and responsibility such as the Board of Directors, the board of trustees, or the owner-manager of the entity) regarding its processes for identifying and responding to the risks of fraud in the entity? Describe the frequency, nature, and extent of such communications.		*	*		
Has management communicated to employees its		*	*		

III.974 Auditing Pronouncements

Questions	Board or the Audit Committee	CEO	CFO	Internal Audit	Others
views on business practices and ethical behavior? If so, how?					
Does the entity have a compliance-monitoring process? If so, describe the process.		*	*		
Describe controls that the entity has established to address risks of fraud the entity has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls.		*	*		
For entities with multiple locations, describe (a) the nature and extent of monitoring of operating locations or business segments, and (b) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist.		*	*		
Has the entity established policies and procedures regarding compliance with laws and regulations (including the prevention of non-compliance)? If so, describe those policies. If not, explain why. What do you do to check compliance with this policy?		*	*		
Has the entity issued directives requiring periodic representations from management at appropriate levels of authority concerning compliance with laws and regulations? If not, why?		*	*		
Has the entity obtained periodic representations from management at appropriate levels of authority concerning compliance with laws and regulations?		*	*		
Has internal audit performed any procedures during the year to identify or detect fraud? If yes, has management satisfactorily responded to any findings resulting from those procedures performed? Note: Consider any significant risks identified when describing the role of those charged with governance (e.g., the Audit Committee) in addressing the risk that management may commit fraud through an override of existing controls.				*	
Other:					

Documentation

APPENDIX 3

(Refer paragraph 78)

Illustrative Fraud Risk Factors

(Refer Appendix I of SA 240)

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.

III.976 Auditing Pronouncements

- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive - including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non-owner managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

Attitudes/Rationalizations

III.978 Auditing Pronouncements

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

- Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
 - Known or anticipated future employee layoffs.
 - Recent or anticipated changes to employee compensation or benefit plans.
 - Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - Inadequate segregation of duties or independent checks.

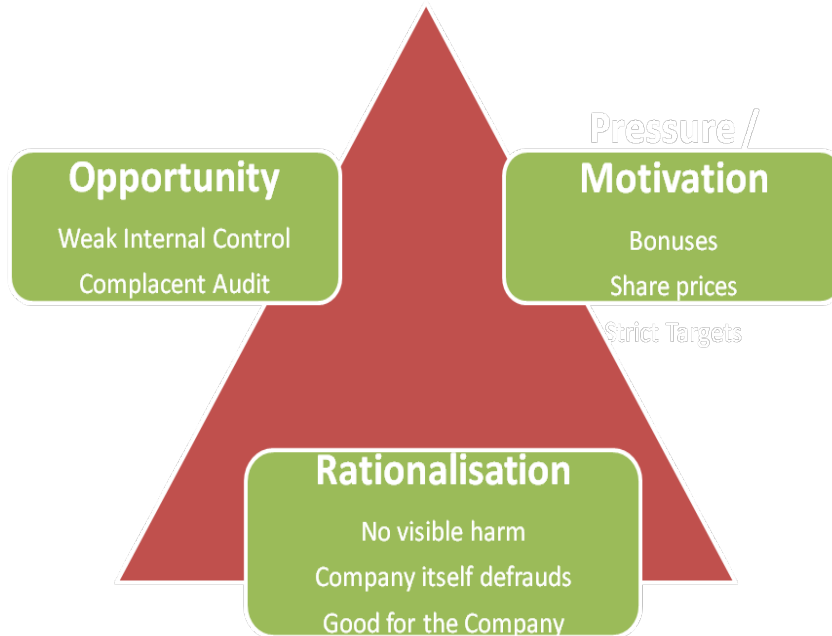
III.980 Auditing Pronouncements

- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

The Fraud Triangle – Risk factors



Additional Examples of Fraud Risk Factors for Consideration by Auditors (these are in addition to those stated in SA 240)

Probable areas where fraud may occur:

- Improper Disclosures.
- Expenses.
- Liabilities.
- Reserves.
- Bribery and kickbacks.
- Cash and bank balances.
- Inflating the purchase consideration for acquisition of business and thereby recording fictitious Goodwill.
- Investments.
- Asset misappropriation.
- Trade Receivable.
- Inventory.
- Revenue Recognition.

Adverse situations impacting the company:

III.982 Auditing Pronouncements

- Heavy rejections of stores, spares and equipment in a factory could be used as means for smuggling good stocks.
- Situation of disorderliness.
- Non-reconciliation of Bank Statements for a long period of time.
- Disaster situations like floods or fire whereby assets are deliberately pilfered.
- Sudden profits in otherwise loss making business not supported by any reasonable change in environment.
- Consistent losses in otherwise thriving industry.
- Situation of incomplete information like missing records.
- Absence of rotation of duties or prolonged exposure in the same area.
- Close nexus with vendors, clients or external parties whereby preference is given to one party over the other though the terms of trade may be unfavorable.
- Domination of management by a single person.

Favorable situations that could also be indicative of fraud:

- One way errors – Where the store keeper always show excessive inventory and has never reported shortages.
- Inefficient accountant suddenly turns very responsible and undertakes extraordinary work such as a reconciliation of long-outstanding/overdue receivable or payable balances, which bears fruits.
- An accountant/employee pays up from his own pocket to make up for the lapse.
- Employee does not take advances/cash float when he goes on outstation tours for company purposes.
- Extreme behavior of being very obedient or friendly or compliant.
- No significant over-dues/delinquencies not commensurate with industry norms.

Common situations in computerised environments where frauds are likely to take place:

- Migration from manual system to computerised system or migration from one application to a new one where migration is enforced on staff, the timeline for migration appears inadequate or parallel alternate records in the erstwhile system are not maintained.
- Implementing computerised system without staff orientation.
- Teething problems in implementation or customisation of computerised systems could be used as camouflaging or cloaking devices for frauds or hiding one's own inefficiencies.
- Frauds using excel spread sheets – cells with values hidden but included in totals; values directly input in cells which normally have formulas or values added in cells which have formulas, etc.

Discrepancies/unusual transactions in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorised balances or transactions.
- Inter-company funding arrangements not in a transparent manner.
- Funding from unknown parties or at valuations that do not appear arm's length.
- Ownership changes in a dormant company or significant business activity in an otherwise dormant company.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorised duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.

Common fraud schemes in revenue recognition:

- Recording of fictitious revenues.
- Recognition of revenue when products or services are not delivered, delivery is incomplete, or delivered without customer acceptance.
- Recognition of revenue from sales transactions billed, but not shipped ("bill and hold").
- Recognition of revenue from excessive shipments to resellers beyond actual demand ("channel stuffing").
- Recognition of revenue from sales where collectability is not reasonably assured.
- Recognition of revenue from sales improperly financed by the selling entity.

III.984 Auditing Pronouncements

- Recognition of revenue for goods on consignment.
- Recognition of revenue when disputes or claims exist.
- Recognition by a lessor of revenue from an operating lease as a sale.
- Failure to establish appropriate provisions for sales discounts and other allowances.
- Failure to establish appropriate provisions for rights to refunds or exchange, cancellation or refusal rights, or liberal unconditional rights of return granted through undisclosed verbal or written agreement (“side agreements”).
- Recognizing inappropriate amount of revenue from swaps or barter arrangements.
- Improper recognition of revenue from long-term contracts (including those accounted for using percentage of completion).
- Recognition of revenue in the wrong period either by holding the books open after period-end or by closing the books prior to period-end.
- Recognition of revenue where there are contingencies associated with the transactions that have not yet been resolved.
- Recognition of revenue associated with undelivered elements of multiple-elements contracts (“bundled contracts”).

APPENDIX 4

(Refer paragraph 79)

Illustrative Possible Audit Procedures to Address the Assessed Risks of Material Misstatement due to Fraud

(Refer Appendix 2 of SA 240)

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor’s assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect. The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.

- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyse selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

III.986 Auditing Pronouncements

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labelled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.

- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts - for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses - Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analysing recoveries of written-off accounts.
- Analysing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.

III.988 Auditing Pronouncements

- Analysing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Possible other audit procedures for consideration by auditors

A. Illustrative Q & A for Evaluating the Fraud Risk Assessment process of the company

Fraud Risk Assessment

1. Does the company have formal and regularly scheduled procedures to perform fraud risk assessments?
2. Are appropriate personnel involved in the fraud risk assessments?
3. Are fraud risk assessments performed at all appropriate levels of the organization (such as the entity level, significant locations or business units, significant account balance or major process level)?
4. Does the fraud risk assessment include consideration of internal and external risk factors (including pressures or incentives, rationalizations or attitudes, and opportunities)?
5. Does the fraud risk assessment include the identification and evaluation of past occurrences and allegations of fraud within the entity and industry? Does it include the evaluations of unusual financial trends or relationships identified from analytical procedures or techniques?
6. Does the fraud risk assessment consider the risk of management's override of controls?
7. Does management consider the type, likelihood, significance, and pervasiveness of identified fraud risks?
8. Are fraud risk assessments updated periodically to include considerations of changes in operations, new information systems, acquisitions, changes in job roles and responsibilities, employees in new positions, results from self-assessments of controls, monitoring activities, internal audit findings, new or evolving industry trends, and revisions to identified fraud risks within the organization?
9. Does management assess the design and operating effectiveness of the fraud risk assessments?
10. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the fraud risk assessments?

11. Is the fraud risk assessment designed and operating effectively?

Control Environment

1. Does the company maintain a proper tone at the top? Did management assess the tone of the organisation to determine if the culture encourages ethical behaviour, consultation, and open communication? (This assessment can be made through inquiries and interviews, or by internal audit review.)
2. Do the audit committee and the Board of Directors have sufficient oversight of management's anti-fraud programs and controls?
3. Does the internal audit function have sufficient involvement in anti-fraud programs and controls, including monitoring of the effectiveness of anti-fraud programs and controls, given the size and complexity of the organization? Does the internal audit function reports directly to the audit committee?
4. Does the company have a published code of ethics/conduct (with provisions related to conflicts of interest, related-party transactions, illegal acts, and fraud) made available to all personnel and does management require employees to confirm that they accept and agree to follow it? Does the frequency of exceptions undermine the code's effectiveness? Does the code comply with all applicable rules and regulations?
5. Does the company have an ethics/whistle blower hotline with adequate procedures to handle anonymous complaints (received from inside and outside the company), and to accept confidential submission of concerns about questionable accounting, internal accounting control, or auditing matters? Are tips and whistle blower complaints investigated and resolved in a timely manner?
6. Does the company have formal hiring and promotion policies, including background checks for those employees with influence over financial reporting or involved in the preparation of the financial statements?
7. Does the company have formal and effective training for employees and new hires on issues of fraud, ethics, and the code of ethics/conduct?
8. Does the company respond in a timely and appropriate manner to significant control deficiencies, allegations or concerns of fraud, and violations of the code of ethics/conduct?
9. Does management assess the design and operating effectiveness of the control environment?
10. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the control environment?

III.990 Auditing Pronouncements

11. Is the control environment designed and operating effectively?

Anti-fraud Control Activities

1. Does the company adequately map or link identified fraud risks to control activities designed to mitigate the fraud risks?
2. Does management design and implement preventative and detective controls (preventative controls are designed to stop fraud from occurring and detective controls are designed to identify the fraud if it occurs)?
3. Does the company have controls that restrain the misappropriation of company assets that could result in a material misstatement of the financial statements?
4. Does the company have controls that address the risk of management's override of controls (including controls over journal entries and adjustments, estimates, and unusual or non-routine transactions)?
5. Does the company consider security controls (including IT controls and limited access to accounting systems), and consider the adequacy of fraud detection and monitoring activities utilizing information systems?
6. Does management assess the design and operating effectiveness of anti-fraud control activities?
7. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of antifraud control activities?
8. Are anti-fraud control activities designed and operating effectively?

Information & Communication

1. Is information on ethics and management's commitment to anti-fraud programs and controls effectively communicated throughout the organisation to all employees?
2. Does management have procedures to disseminate and collect information regarding anti-fraud programs and controls, fraud risks, allegations of fraud, and concerns of improper accounting to and from all levels of the organization and external parties (where appropriate)?
3. Does management assess the design and operating effectiveness of information and communication?
4. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of information and communication?

5. Are procedures and activities for communicating information regarding anti-fraud programs and controls designed and operating effectively?

Monitoring Activities

1. Are internal audit and others actively involved in monitoring and assessing anti-fraud programs and controls?
2. Is the internal audit activity adequate for the size and operations of the organization?
3. Are findings and weaknesses identified during monitoring activities incorporated back into the fraud risk assessment, the design of the control environment and anti-fraud control activities?
4. Does the audit committee have oversight of monitoring activities?
5. Does management assess the design and operating effectiveness of monitoring activities?
6. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the monitoring activities?
7. Are monitoring and assessment activities designed and operating effectively?

B. Additional examples of audit procedures to address fraud risk factors

Incorporate “element of surprise” in the audit procedures and timeliness

- Existence of assets is generally confirmed through physical verification. To re-verify the existence of assets at a later date to ensure that they were not borrowed or temporarily created.
- Compliance tests of internal controls, disbursement of wages, procedures for obtaining quotations for sale and disposal of scrap, material weighments, etc. can be verified repeatedly. Such procedures may reveal inconsistencies, if any.
- Element of unpredictability/surprise should be incorporated in physically verifying stocks with third parties.
- Rotate the components between audit team members to overcome familiarity threat with regard to audit procedures.
- Visiting locations or performing certain tests on a surprise or unannounced basis.

Apply test of reasonableness and test of absurdity

III.992 Auditing Pronouncements

- Existence of vendor/customer website for all huge value bills and payments. Also check the date on which the website was hosted. A recently uploaded webpage is also suspicious.
- Two or more employees arriving and departing at the same time consistently.
- Are stocks ordered irrespective of large existing balances.
- Whether value of property acquired is within the acceptable range of prevailing market value.
- Check for inconsistent facts while reading the contracts and agreements.

Search for mutually exclusive events

- Production quantity cannot be greater than machine capacity; sales cannot be quantitatively greater than opening stocks plus purchases/production.
- Production cannot be possible in periods of strike, downtime etc.
- Fuel for diesel cars cannot be supported by petrol bills or *vice versa*.
- Stocks cannot be physically greater than the volumetric capacity of storage place.
- An employee who has left cannot approve any transactions after the date of departure or before the date of appointment.
- Yield and rejection ratio for identical machines in different locations should theoretically be the same.
- Sales returns and warranty claims for the same products across different sales locations should be more or less consistent. If they are grossly inconsistent, analyse reasons.

Possible Other Audit Procedures – Cash and Bank

Risks	Audit Procedures
Cheque signing mandate given to more number of persons which is not commensurate with the nature, size of the business. This may increase the risk of collusion between cheque signing authorities in remote locations	Review the cheque signing mandate for both crossed and bearer cheque. Evaluate whether the authority levels set are strong and is commensurate with the nature and size of the business.

Possibilities of cheques being forged and payment vouchers being approved by unauthorised persons	Obtain specimen signatures of all authorised signatories and share it with the engagement team members during the planning stage.
Snowballing of bank charges and forex gains/losses	Check all cash contras and inter-back transfers – Ensure that cash withdrawals as per the bank statement is reflected as cash withdrawal in the bank book as well on the same date.
Duplicates in cheque numbers could indicate double accounting of expense or payment.	The “IF” function in Excel along with its derivative usage with “And/or” can be useful for detecting gaps, finding duplicates and locating multiple records.
Gaps in cheque numbers may indicate that some cheques have been deliberately kept aside for some other motives which certainly is a concern	The “IF” function in Excel along with its derivative usage with “And/or” can be useful for detecting gaps, finding duplicates and locating multiple records.
Cash withdrawals or other transactions as per bank statement accounted differently in the bank book	Obtain a list of bank accounts held and ascertain the purpose for which each bank account is used. On a sample basis, select one month each for each of the bank accounts, obtain bank statements directly from the bank and re-perform bank reconciliation statements.

Possible Other Audit Procedures – Test of Details

Tests	Purpose	Procedures
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III.994 Auditing Pronouncements

Physical voucher consistency test in a series	<ul style="list-style-type: none">• Helps identify replacement or insertion of a new voucher.• Can be applied for cash and bank payments, supplier invoices from the same supplier, purchase vouchers, journal vouchers etc.	<p>a) Is the paper relatively new or has it yellowed less in comparison with other vouchers around the same date.</p> <p>b) Are the routine ticks missing.</p> <p>c) Is the paid stamp missing.</p>
Specimen signatures comparison test	Helps to identify simple forgeries or fictitious transactions.	To obtain specimen signatures of all signatories and keep them for comparison during vouching.
Chronological test of supporting vouchers	Helps in identifying fraudulent/fictitious bills when huge bunches of supporting vouchers are attached to a single voucher.	Check if the supporting vouchers are dated subsequent to the payment voucher date or the date relates to earlier periods?
Chronological test of approvals	Helps to identify if any vouchers were approved by the resigned/newly joined employee after the resignation date or before the joining date.	If any of the authorised signatories had resigned or newly joined during the year, along with the specimen signatures also obtain their date of resignation or joining.

Possible Other Audit Procedures – Management Override of Controls

- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and verifying any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, verifying the possibility of related parties and the sources of financial resources supporting the transactions.
- Use of statistical tool for sample selection.
- Reviewing large and unusual expenses.
- Reviewing the authorisation and carrying value of senior management and related party loans.

- Reviewing the level and propriety of expense reports submitted by senior management.

Possible Other Audit Procedures – Revenue Recognition

- Comparing revenue reported by month/product line/remote locations during the current reporting period with comparable prior periods.
- Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel to corroborate information relating to sales returns, discounts, shipments near the end of the period etc.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment
- Risk of understating/not accounting scrap sales.

Possible Other Audit Procedures – Inventory

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Analysing inventory shortages by location or product type.
- Performing additional procedures during the observation of the count, for example:
 - more rigorously examining the contents of boxed items,
 - the manner in which the goods are stacked (for example, hollow squares) or labeled,
 - the quality (that is, purity, grade, or concentration) of liquid substances such as oil or specialty chemicals.
 - take the help of technical experts to weigh/measure inventory.

Possible Other Audit Procedures – Vendor and Customer

- Check for duplicate vendor IDs, contact number, bank account number.
- Obtaining back dated cheques from customers and credit to customer based on instrument date and not the deposit date to reduce the outstanding debtors and also to reduce the penal interest.

III.996 Auditing Pronouncements

- Unidentified credit balances have possibility of being misused by way of wrong credits to suppliers, customers, accomplices and could also facilitate teeming and lading of collections.
- Analysing recoveries of written-off accounts.
- Receivables growing faster than revenues.

Possible Other Audit Procedures – Employees

- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.

Appendix 5

(Refer paragraph 87)

Illustrative Format for Reporting to Board or the Audit Committee on Fraud

(As required by Rule 13(2)(a) and Rule 13(3) of the Companies (Audit and Auditors) Rules, 2014
[as amended by the Companies (Audit and Auditors) Amendment Rules, 2015

Date:

Subject: Report under Sub-section (12) of Section 143 of the Companies Act, 2013 on suspected offence involving fraud being committed or having been committed against the company by its officers or employees.

S.No	Particulars	Details
1(a)	Name of the Company ⁴	
1(b)	CIN	
1(c)	Address of the Registered Office	
2(a)	Name of the auditor or auditor's Firm ⁵	
2(b)	Membership number	
2(c)	Address	

⁴ Where the suspected offence relates to any component (subsidiary, associate, joint venture) forming part of the consolidated financial statements, to include and specify accordingly.

⁵ Where the period of offence dates back to an earlier time period, where the current auditor was different, to indicate the name of the predecessor auditor.

S.No	Particulars	Details
3	Date of the annual general meeting when the auditor was appointed or reappointed	
4	SRN and date of filing	
5	Address of the office or location where the suspected offence is believed to have been or is being committed	
6	Full details of the suspected offence involving fraud (attach documents in support) ⁶ (Refer Note 1)	
7	Particulars of the officers or employees who are suspected to be involved in the commission of the offence, if any:	
7(a)	Name (s)	
7(b)	Designation	
7(c)	If Director, his DIN	
7(d)	PAN	
8	Basis on which fraud is suspected ⁷	
9	Period during which the suspected fraud has occurred	
10	Date of sending report to the Board or Audit Committee as per rule 13(2)(a)	
11	Estimated amount involved in the suspected fraud (Refer Note 2)	
12	Any other relevant information	

Notes:

- The details of suspected offence involving fraud are those that have arisen during the course of performance of duties by the auditor and hence the auditors do not offer any assurance on completeness of the said matter or any other matter that may not be knowledgeable to the auditor.

⁶ Supports would relate to the convincing evidence that supported the suspicion of the auditor.

⁷ With respect to the suspected fraud, briefly state procedures performed, the audit evidence obtained and the conclusions on evaluation of the audit evidence.

III.998 Auditing Pronouncements

2. The estimated amount indicated in Point No. 11 in the table above is based on the available information and evidence relating to the suspected fraud that supports the suspicion of the auditor. It is expected that based on this reporting by the auditors, Those Charged with Governance would initiate an investigation/forensic audit and provide complete details to the auditor to enable him to report to the Central Government and also to assess the impact of the same on the financial statements.

APPENDIX 6

(Refer paragraphs 3 and 103)

Form No. ADT-4		
REPORT TO THE CENTRAL GOVERNMENT		
(See rule 13(2)(f) of the Companies (Audit and Auditors) Rules, 2014) [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015]		
Date:		
Subject: Report under sub-section (12) of section 143 of the Companies Act, 2013 on suspected offence involving fraud being committed or having been committed		
1)	(a)	Name of the Company
	(b)	CIN:
	(c)	Address of the Registered Office:
2)	(a)	Name of the auditor or auditor's Firm
	(b)	Membership Number
	(c)	Address
3)	Date of the annual general meeting when the Auditor was appointed or reappointed	
4)	SRN and date of filing	
5)	Address of the office or location where the suspected offence is believed to have been or is being committed	
6)	Full details of the suspected offence involving fraud (attach documents in support)	
7)	Particulars of the officers or employees who are suspected to be involved in the	

<p>commission of the offence, if any:</p> <p>a) Name(s) :</p> <p>b) Designation</p> <p>c) If Director, his DIN</p> <p>d) PAN</p> <p>8) Basis on which fraud is suspected:</p> <p>9) Period during which the suspected fraud has occurred</p> <p>10) Date of sending report to the Board or Audit committee as per rule 13(2)(a)</p> <p>11) Date of reply received from Board or Audit committee, if any and if so received, attach copy thereof and give gist of the reply</p> <p>12) Whether the auditor is satisfied with the reply of the Board or Audit committee. Yes _____ No _____.</p> <p>13) Estimated amount involved in the suspected fraud;</p> <p>14) Details of steps, if any, taken by the company in this regard; (Furnish full details with references)</p> <p>15) Any other relevant information.</p>
<p>VERIFICATION</p> <p>I,, Proprietor/Partner of, Chartered Accountants do hereby declare that the information furnished above is true, correct and complete in all respects including the attachments to this form.</p> <p style="text-align: right;">(Name, Signature and Seal of the Auditor)</p>
<p>Attachments:</p> <p>1. Optional attachments</p>

APPENDIX 7

(Refer paragraph 105)

Illustrative Management Representation Letter

(for the reply of the Board or the Audit Committee on fraud reported by the auditor under Rule 13(2)(b) and (d) and Rule 13(3) and (4) of Companies (Audit and Auditors)

III.1000 Auditing Pronouncements

Rules, 2014) [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015]

[Letterhead of the Entity]

Messrs. *Name of the Audit Firm*

Chartered Accountants

Dear Sirs,

This representation letter is provided in connection with our reply dated ___ to you pursuant to your letter dated ___ on fraud suspected by you and reported to us under Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015.

We understand that the fraud reported by you is as follows:

(Details of fraud reported by the Auditors)

We acknowledge that because of the inherent limitations of an audit, together with the inherent limitations of internal controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed by the auditor in accordance with the Standards on Auditing and that the matter reported by you in your letter dated ___ is not exhaustive or complete list of frauds against the Company that may exist.

We acknowledge our responsibility for the prevention and detection of fraud. Our responsibility also includes informing you about any fraud detected and remedied by the management, any incidence of fraud reported through the vigil mechanism or through any other internal or external sources. We acknowledge that we are also responsible to take appropriate action when a fraud is detected or reported through any of the sources.

In particular we confirm that we are responsible for the following:

- a) Designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of the financial statements which are free from material misstatements, whether due to fraud or error.
- b) To set up a vigil mechanism for reporting suspected fraud and administer the mechanism effectively.
- c) Take appropriate action to detect the fraud and wrongful gain or loss, if any, incurred on account of the fraud.
- d) Take appropriate action against the fraudsters.

- e) Address the control weaknesses which were the root cause for fraud and strengthen the internal control system.

We confirm the following representations in respect of fraud noted and reported during the year/period, other than for the matters reported by you:

1. There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices [except for (*insert appropriate description*)].
2. We have disclosed to you all changes/deficiencies in the design or operation of internal controls over financial reporting identified as part of our assessment, including separately disclosing to you all such deficiencies that we believe to be significant deficiencies or material weaknesses in internal controls over financial reporting.
3. We acknowledge our responsibilities for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
4. We are not aware of any/We have disclosed to you all significant facts relating to any frauds or suspected frauds known that may have involved (i) Management; (ii) Employees who have significant roles in accounting and internal control; or (iii) Others.
5. To the best of our knowledge and belief, the Company has not made any improper payments or payments which are illegal or against public policy.
6. The Company has complied with all aspects of contractual agreements which could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.
7. We have no plans or intentions which may materially affect the carrying value or classification of assets and liabilities reflected in the financial statements.
8. We have made available to you all books of account, supporting documentation and minutes of all meetings of the shareholders and the Board of Directors and Committees of the Board and all other details with regard to action taken by the management to evaluate the fraud reported by you.
9. We have acted in good faith and in the best interests of the Company regarding the action taken by the management to evaluate the fraud reported by you.

III.1002 Auditing Pronouncements

10. We have not withheld from you any relevant information that we are aware of and would have an implication on the process of your responsibilities to report fraud under the statute.
11. The conclusions reached by us are based on the rationale of facts and data that were identified during the investigation/other action taken by us to evaluate the fraud reported by you.
12. We believe that appropriate action has been taken against employees/officers involved in the fraud and we confirm that appropriate controls have been put in place to ensure that such incidences are avoided in the future.

With effect from 1st April 2014, the provisions of the Companies Act, 2013 ('the Act') have become applicable to the Company. We understand that Section 143(12) of the said Act read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, as amended by the Companies (Audit and Auditors) Amendment Rules, 2015 requires the auditors to report on fraud to the Board or the Audit Committee prior to reporting the same to the Central Government. We are aware that the Board or the Audit Committee is required to consider the report of the auditor and respond on the matter reported within 45 days of the date of the report of the auditor.

Insofar as the matter reported by you in your letter dated ___ and our reply thereto dated ____, we confirm the following:

1. We have carried out an investigation into the matter reported by you towards which ____, an independent agency/the Company's internal auditor/Senior Management of the Company were engaged to investigate the matter.
2. Status of the investigation commissioned by the Board or the Audit Committee.

I. Investigation complete and Board or the Audit Committee concurs with the auditor on the suspected fraud

1. We concur with your assessment of suspected fraud based on the following: (State details and the reasons for occurrence).
2. The persons allegedly involved in the matter are: (list names and designations, DIN (if a Director is involved) and PAN of the person).
3. Based on the investigation carried out, we confirm that the period to which the fraud relates is _____.
4. The estimate of amounts involved in the fraud as determined by the investigation is Rs. _____.
5. We have initiated the following steps with immediate effect to mitigate the recurrence of such fraud. (State steps taken to mitigate such risk in future).

6. We have initiated the following actions on the persons involved in the fraud (List action taken on the concerned persons.) [or] Pending closure of the internal hearings of the Committee of Ethics of the Company, no action has been taken on the persons involved.

II. Investigation complete and Board or the Audit Committee does not concur with the auditor on the suspected fraud

1. State reasons for not concurring with the auditor's assessment of suspected fraud with persuasive evidence supporting the Board or the Audit Committee conclusion.
2. We believe that the investigation commissioned by us was independent, comprehensive, objective, unbiased and did not involve any scope limitations. Specifically, the investigation focused on the following areas that are impacted by the suspected fraud reported by you: (list areas)
3. We confirm that no fraud has been or is being committed against the Company by its officers or employees as reported by you.

III. Investigation is in progress

1. As on date of this letter, the investigation commissioned by the Board or the Audit Committee is in progress.
2. Management to state items in I.3 to I.8 to the extent applicable.

We acknowledge that your report on suspected fraud under Section 143(12) of the Act is made in good faith to comply with the requirements of the law and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the Act or of any rules or orders made thereunder.

Yours faithfully,

Chairman of the Audit Committee/Board